

# **An Introduction to Islamic Finance**

*Theory and Practice*

SECOND EDITION

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ZAMIR IQBAL  
AND ABBAS MIRAKHOR



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*In the Name of Allah, the All Merciful, the All Beneficent*

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# Glossary of Arabic terms

## A

- ajar*: Reward for doing good  
*akhlaq*: Personality disposition stemming from individual character  
*akl amwal alnas bi al-batil*: Enrichment through non-permissible means  
*al-adl*: Justice  
*al-amal*: The concept of work  
*al-bay'*: Exchange  
*al-ihsan*: Behaving with full consciousness of the Supreme Creator  
*al-khiyar/khiyar*: Option  
*al-mal*: Wealth or property  
*al-Mo'meneen*: Active believers  
*amanah*: Trust  
*aqidah*: Binding principles of faith  
*awqaf* (sing. *waqf*): Endowments

## B

- bai' bithamin ajil (BBA)*: Sales contract where payment is made in installments after delivery of goods. Sale could be for long term and there is no obligation to disclose profit margins  
*barakah*: An invisible but "material" blessing whose results can be observed by any believer who engages in righteous conduct  
*bashar*: Man. This concept refers to the physical/outward attributes, rather than the inner character  
*bay'*: Contracts of exchange  
*bay' al-arabun*: A portion of the full sale price paid in good faith as earnest money (could be considered as non-refundable down payment)  
*bay' al-dayn*: Sale of debt or liability  
*bay' al-istisna'*: Sale on order (usually manufactured goods)  
*bay' al-muajjal*: Deferred-payment sale, either by installments or a lump sum  
*bay' al-salam* (also *salaf*): Sale in which payment is made in advance by the buyer and the delivery of the goods is deferred by the seller

## D

- dayn*: Debt  
*dharoorah*: Necessity

## F

**faddl:** Addition

**faqih** (pl. *fuqaha'*): Jurist who gives rulings on various issues in the light of the *Qur'an* and the *sunnah*

**fatwa:** Religious verdict by *fuqaha'*

**fiqh:** Corpus of Islamic jurisprudence. In contrast to conventional law, *fiqh* covers all aspects of life—religious, political, social, commercial, and economic. *Fiqh* is based primarily on interpretations of the *Qur'an* and the *sunnah* and secondarily on *ijma'* and *ijtihad* by the *fuqaha'*. While the *Qur'an* and the *sunnah* are immutable, *fiqhi* verdicts may change in line with changing circumstances

**fiqhi:** Relating to *fiqh*

## G

**ghabun:** The difference between the price at which a transaction is executed and the fair price (unjustified exploitation, loss)

**gharar:** Literally, “deception, danger, risk, and excessive, unnecessary uncertainty (ambiguity).” Technically, it means exposing oneself to excessive risk and danger in a business transaction as a result of either having too little information or asymmetric information about price, quality and quantity of the counter-value, the date of delivery, the ability of either the buyer or the seller to fulfill their commitment, or ambiguity in the terms of the deal—thereby, exposing either of the two parties to unnecessary risks

## H

**hadial/hibah:** Gifts

**hadith** (pl. *ahadith*): Oral tradition of the Prophet Muhammad (pbuh) as narrated by his companions

**hajj/umra:** The pilgrimage to Mecca

**hajr:** Blocking the use of a resource

**haram:** Prohibited

**hawala:** Bills of transfer

**hifz al-mal:** Protection of wealth or property

**hila** (pl. *biyal*): Refers to strategies in applying juristic rules to ease constraints on a particular transaction that would have been non-permissible otherwise

## I

**'ibada** (pl. *ibadat*): Adoration of Allah (*swt*) through rule compliance

**ijarah:** Leasing. The sale of the usufruct of an asset. The lessor retains the ownership of the asset with all the rights and the responsibilities that go with ownership

**ijarah sukuk:** Instrument issued on the basis of an asset to be leased. The investors provide funds to a lessor (say, an Islamic bank). The lessor acquires an asset (either existing or to be created in future) and leases it out if it is not already leased out. They are issued by the lessor in favor of the investors, who become owners of the leased asset in proportion to their investment. These entitle the



holders to collect rental payments from the lessee directly. Can also be made tradable in the stock exchange

***ijarah wa "qtinah"***: Hire-purchase agreement

***ijma***: The consensus of jurists

***ijtihad***: Exertion of personal effort to understand the wisdom behind the prescribed rules and/or efforts to extend juristic rulings to new situations based on study of the *Qur'an* and *hadith*

***ikrah***: Coercion

***iman***: Active belief

***insan***: This concept refers to a "human being" who is fully conscious of the human state in relation to the Supreme Creator. cf. *bashar*

***israf***: Overspending

***istihsan***: Judicial preference

***istisna'*** (short form for *bay' al-istisna'*): A contract whereby a manufacturer (contractor) agrees to produce (build) and deliver well-described products (or premises) at a given price on a given date in the future. The price need not be paid in advance and may be paid in installments in step with the preferences of the parties, or partly at the front end and the balance later on, as agreed

***itlaf***: Waste

***itraf***: Opulent and extravagant spending

## J

***jo'alab***: Performing a given task for a prescribed fee in a given period

## K

***kanz*** (pl. *konooz*): Treasure(s). Refers to wealth held in the form of gold, silver, and other precious metals

***khalifa***: Vicegerent, trustee

***khawf***: Fear of the consequences of thoughts and actions

***khilafah***: Trusteeship, stewardship

***khisarab***: Loss

***khums***: One-fifth of income payable for the purpose of redeeming the rights of others

***kifala***: Taking responsibility for someone else (see also *takaful*, which is derived from this)

## M

***ma'aad***: The ultimate return of everything to the Creator for the final accountability and judgment

***madhabib***: School of thought

***manafaah al-ikhtiyarat***: Gains from taking options

***manfaa maal/ manfa' ah***: Usufruct. Benefit flowing from a durable commodity or asset. Also, gains from transaction

***maqasid al-Shari'ah***: Basic objectives of the *Shari'ah*: the protection of faith, life, progeny, property, and reason

**maslahah:** Literally, “benefit.” Technically, it refers to any action taken to protect any one of the five basic objectives of the *Shari’ah*

**mithaq:** A covenant

**muamalat:** Interpersonal transactions

**mubaya’a:** Contract between the ruler and the community that he will be faithful in discharging his duties in compliance with the rules prescribed by Allah (*swt*)

**mudarabah:** Contract between two parties—a capital owner or financier (*rabb al-mal*) and an investment manager (*mudarib*). Profit is distributed between the two parties in accordance with the ratio upon which they agree at the time of the contract. Financial loss is borne only by the financier. The investment manager’s loss lies in not getting any reward for his labor services

**mudarib:** Investment manager

**muhtasib:** A market supervisor

**murabahah:** Sale at a specified profit margin. This term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in installments or as a lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. Also referred to as *bay’ mu’ajjal*

**musharakah:** Partnership. Similar to a *mudarabah* contract, the difference being that here both partners participate in the management and the provision of capital and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each one’s share in the capital. Also, this contract is more suitable for longer-term partnership contracts and long-gestating projects

**musharakah ‘aqd:** The contract of *musharakah*

**musharakah mulk:** Specification of property rights of partnership

**musharakah mutanaqisah:** “Diminishing partnership”

**mysir:** Gambling or any game of chance

## N

**nafaqah:** Expenditure

**nafs:** The psyche (sometimes translated as “soul”)

**nisab:** A level of wealth beyond which levies are due

**niyyah:** Intention

## Q

**qard:** A loan

**qard-ul-hassan:** Loan extended without interest or any other compensation from the borrower. The lender expects a reward only from Allah (*swt*)

**qimar:** Gambling

**qist:** Social (inter-relational) justice

**qiyas:** Analogy

**Qur’an** (also written as *al-Qur’an*): The Holy Book of Muslims, consisting of the revelations made by Allah (*swt*) to the Prophet Muhammad (pbuh). Prescribes the rules of social and personal behavior, compliance with which guarantees social solidarity, economic growth and development

## R

**rabb al-mal:** Capital owner or financier

**rahn:** a pledge (also translated as “collateral”)

**riba:** Literally, “increase,” “addition” or “growth.” Technically, it refers to the “premium” that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Interest, as commonly understood today, is regarded by a predominant majority of *fuqaha*’ to be equivalent to *riba*

**ribh:** Profit

## S

**sadaqat:** Payments to redeem others’ rights(also translated as “charity”)

**safih:** A person of weak understanding

**sarf:** An exchange contract

**sarrafs:** Exchange dealers

**Shari’ah:** The corpus of Islamic law based on Divine guidance, as given by the *Qur’an* and the *sunnah*, and embodies all aspects of the Islamic faith, including beliefs and practices

**shirakah:** Partnership.

**suftaja:** Bills of exchange

**sukuk:** Negotiable financial instruments

**sunnah:** The second-most important source of the Islamic faith after the *Qur’an* and refers to the Prophet’s (pbuh) operationalization and explication of the rules prescribed by Allah (*swt*) in the *Qur’an* in words and action

**surah:** A chapter of the *Qur’an*

## T

**tabdhir:** Squandering

**takaful:** An alternative to the contemporary insurance contract. A group of persons agree to share a certain risk (for example, damage by fire) by collecting a specified sum from each. Any loss is met from the collected funds

**taqwa:** Awe/fear that comes with consciousness of the presence of Allah (*swt*)

**tawarruq:** Reverse *murabahah*. Buying an item on credit on a deferred-payment basis and then immediately reselling it for cash at discounted/prize to a third party

**tawhid:** The Unity and Oneness of the Creator

**tijÉrah/tirajah:** Contracts of trade

## U

**urf:** Customs

## W

**wa’d:** A time-bound promise to deliver on terms contracted

**wadia:** Trust or safe keeping

*wakalah/wikala:* Contract of agency in which one person appoints someone else to perform a certain task on his behalf, usually for a fixed fee

*wali:* A protective, loving friend

*waqf* (pl. *awqaf*): Endowment

## Z

*zakah/zakat:* Amount payable by a Muslim on his net worth as a part of his religious obligations to redeem the rights of others

## CHAPTER 1

# Introduction

Islam propounds the guiding principles, and prescribes a set of rules, for all aspects of human life, including the economic aspect. How, and to what degree, would an economic and financial system designed in conformity with the principles of Islam be different from a modern, conventional, non-Islamic system? How would such a system deal with the questions of the allocation, production, exchange, and distribution of economic resources? How can some of its fundamental principles be explained with due analytical rigor? Researchers interested in contemplating or devising a social, economic, and financial system based on the tenets of Islam are familiar with these and many other such questions.

It is only in the past few decades that efforts have been made to explain Islamic financial and economic principles and rules in modern analytical terms and, despite considerable published research, there is still some confusion in regard to applying a precise definition to various social sciences prefixed with the term “Islamic,” such as “Islamic economics” or “Islamic finance.” One of the main reasons for this confusion is the tendency to view different aspects of such a system in isolation, without looking at it in its totality. For example, the term “Islamic finance” is often deemed to denote a system that prohibits “interest.” However, this simple description is not only inaccurate but is itself a source of further confusion. Unfortunately, too, a number of writers have taken the liberty of expressing opinions on these issues without sufficient knowledge of Islam, its primary sources, its history and often without even a working knowledge of Arabic—the language of Islam.<sup>1</sup> Against the backdrop of a politicized atmosphere, such attempts render an understanding of these issues even more difficult.

Systematic thinking by professional economists about Islam and economics has had a short history compared to both the remarkable earlier period of vibrant scholarship in the sciences and humanities in the Muslim world and to the long “hibernation”<sup>2</sup> that followed it. This earlier period witnessed major achievements in all areas of Muslim scholarship and gave rise to dynamic economic growth in Muslim societies. History has recorded how these contributions, discoveries and intermediation by Islamic sciences

actually helped facilitate the development and growth of Western societies and economies. When measured against the last three decades of research and development in other disciplines, it is clear that this hibernation is now over and the published writings on Islamic economics in various languages are testimony to a return of vibrancy and energy in the discipline. These efforts are directed toward the development of a coherent and rigorous explanation of how Islam proposes to organize an economic system by answering the fundamental questions of what should be produced, how and for whom; how decisions should be made and by whom; and, finally, how Islamic institutions could be revived to address the problems of modern societies.

## **FOUNDATIONAL CONCEPTS**

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Islam postulates a unique nexus of contracts among the Creator, man and society on the basis of the Divine Law that directly affects the workings of the various social, political, economic, and financial systems. Therefore, to understand the way in which economic affairs are to be organized in an Islamic system, it is first necessary to comprehend the nature of this relationship. What differentiates Islam from other systems of thought is its unitary perspective, which refuses to distinguish between the sacred and the profane and which insists that all of its elements must constitute an organic whole. Consequently, one cannot study a particular aspect or part of an Islamic system—its economic system, say—in isolation, without an understanding of the conceptual framework that gives rise to that part or aspect, any more than one can study a part of a circle without conceptualizing the circle itself.

The economist Douglas North contends that what distinguishes one economic system from another is the “institutional scaffolding”—the collection of rules and norms along with their enforcement characteristics—in that system. He defines institutions as rules of behavior designed to impose constraints on human interaction. These institutions “structure human interaction by providing an incentive structure to guide human behavior. But an incentive structure requires a theory of the way the mind perceives the world and its functioning so that institutions provide those incentives” (North 2005: 66). It is at this point that paradigms become relevant because paradigms in economics do have conceptions of man, society and their interrelationships. A paradigm can be defined as a conception of reality composed of a theoretical and empirical structure in a given field. When a critical mass of practitioners accepts that structure, that conception of reality becomes a paradigm. Such conceptions are themselves products of a meta-framework lurking in the background whose elements may or may not be explicitly specified but which, nevertheless, exist in the mind of the designer prior to the construction and presentation of a paradigm. For example, the meta-framework of neo-classical economics is classical economics, as the name implies.

There are basically two meta-frameworks that underlie all economic paradigms: Creator-centered or man-centered. The former derives its economic

analysis from rules of behavior (institutions) prescribed by the Creator for individuals and societies. Examples are economic paradigms that are based on Abrahamic traditions, Judaism (see, for example, Tamari 1987), Christianity (see, for example, Long 2000) and Islam. The latter, the secular tradition, takes as given, or derives, rules of behavior (institutions) that are designed by humans and approved by society.

The meta-framework for Islam specifies these rules of behavior within the context of its fundamental principles. The core and fundamental axioms of Islamic ideology are the belief in (1) the Unity and Oneness of the Creator (*tawhid*), (2) the prophethood (*Nubuwwa*), and (3) the ultimate return of everything to the Creator for the final accountability and judgment (*Ma'aad*).

The first and most important of these principles is the Oneness and Uniqueness of the Creator, a corollary of which is the unity of the creation, particularly the unity of mankind. The axiom of Unity and Oneness of the Creator requires the belief that all creation has one omniscient and omnipresent Creator—Allah (*swt*)—who has placed humans on this earth to pursue their own felicity and perfection.<sup>3</sup> Further, it requires that the orbit of man's life is seen to be much longer, broader and deeper than the material dimension of life in this world.

A corollary of the axiom of the Unity of the Creator is that all His creation constitutes a unity as well. The *Qur'an* (31:28) calls attention to the fact that despite all apparent multiplicity, human beings are fundamentally of one kind; they were created as one being (*nafs*) and will ultimately return to Allah (*swt*) as one as well.

In a series of verses, the *Qur'an* exhorts people to take collective and unified social action to protect the collectivity from all elements of disunity.<sup>4</sup> These and many other verses order human beings to work hard toward social unity and cohesion in constructing their societies, and preserve and defend that unity. Unity and social cohesion are so central among the Divine objectives set out for mankind in the *Qur'an* that it can be argued that all conduct prohibited by Islam is that which ultimately leads to disunity and social disintegration. Conversely, all righteous conduct prescribed by Islam is that which leads to social integration, cohesiveness and unity. As a result, Islam is a call both to the individual and to the collective and has given the latter an independent personality and identity, which will be judged on its own merits or demerits separately from the individuals that constitute the collectivity. The final judgment on individual actions will have two dimensions: one as the individual and the other as a member of the collectivity.

The second fundamental principle is the belief in the Creator's appointment of individuals to serve as His messengers and prophets to others of their kind. These are very select among humans. Every messenger and prophet affirmed and confirmed the messages revealed before them and invited the people of their time and place to remind people of the rules of behavior contained in the revelation and to apply those rules in accordance with the added complexity of human life and the growth of human consciousness at

specific points in time. The final, universal, perfect message was then delivered by the last of the messengers, Muhammad (pbuh).<sup>5</sup>

At some point in the cycle of life, each individual will be called to account to Allah (*swt*) for his/her actions and will be judged accordingly in the “life hereafter.”

These three axioms are comprehensive and govern all of man’s actions and decisions, and constitute an integrated, consistent and unified whole; compliance with these rules leads, in turn, to the unity of human society.

The meta-framework envisions an ideal society as one composed of believers committed to complying with the Creator’s rules. The individual members are aware of their “oneness” and conscious of the fact that self-interest is best served by seeing “others as themselves.” Such a society is one of the “golden mean” that avoids extremes, and a society that is so rule compliant that it serves as a benchmark for and a witness to humanity (*Qur’an* 2:143). This is a society which actively encourages cooperation in socially beneficial activities and prohibits cooperation in harmful ones (*Qur’an* 3:104, 110, 114; 9:71). Moreover, in this society, consultation, at both individual and collective levels, is institutionalized in accordance with the rule prescribed by Allah (*swt*) (*Qur’an* 3:159; 42:38; 2:233). Similarly, all other rules of behavior prescribed in the *Qur’an* are institutionalized with a sufficiently strong incentive structure to enforce rule compliance; the objective being the establishment of social justice. The internalization of the rules of behavior by individuals and their institutionalization, along with the incentive structure and enforcement mechanism, reduces uncertainty and ambiguity in decision–action choices confronting the individual and the society.

The structure of such a paradigm can be described as being composed of a meta-framework and an archetype model. The former specifies rules (institutions) that are, to a degree, abstract and immutable. The archetype model articulates the operational form of these rules in a human community. The meta-framework specifies the immutable, abstract rules. The archetype model demonstrates how these rules are operationalized in a human community. The meta-framework specifies general universal laws, rules of behavior. The archetype model provides specific universal rules of behavior and the institutional structures needed for organizing a human society based on the immutable rules of the meta-framework (Mirakhor and Hamid 2009).

The abstract became operational in the hands of the one human being who was the one and only direct recipient of the source of the meta-framework; that is, the *Qur’an*. Through the words and actions of this perfect human, the meta-framework given by the Creator in the *Qur’an* was interpreted, articulated and applied to the immediate human community of his time. As the spiritual authority for his followers, he expounded, interpreted, and explained the content of the *Qur’an*. In his capacity as the temporal authority the messenger operationalized the rules (institutions) specified in the *Qur’an* in Medina. The economic system established in Medina is the archetype of Islamic economic systems and provides a core institutional structure which is immutable.



## WHY IDEOLOGY MATTERS

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The strength of ideology determines the strength of rule compliance, and therefore the strength of institutions, which, together with technology, determine the performance and efficiency of an economic system. Efficiency is measured by the cost of a given level of economic performance. The stronger the ideology, the less the divergence between the choices individuals make and those expected of them by the objectives of institutions, and, consequently, the lower the cost of enforcement of contracts and rules of conduct. By implication, in an ideal situation, with a strong ideology, in which all rules of conduct are complied with and are universally enforced, there will be no divergence between what institutions expect of individual choices and the actual choices. Therefore, in the ideal situation, asymmetry and moral hazard are minimized since a large part of uncertainty will be eliminated with rule compliance. The remaining risks will become insurable.

## ISLAM'S CONCEPT OF JUSTICE

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As mentioned earlier, a central aim of Islam is to establish a just and moral social order through human agency. This all-embracing desideratum of the Islamic system is the ruling principle from which human thought and behavior, the substantive and regulative rules of the *Shari'ah*, the formation of the community and the behavior of polity and of political authority derive their meaning and legitimacy. It is this emphasis on justice that distinguishes the Islamic system from all other systems. It is via the concept of justice that the *raison d'être* of the rules governing the economic behavior of the individual and economic institutions in Islam can be understood. What gives the behavior of a believer its orientation, meaning, and effectiveness is acting with the knowledge that justice evokes Allah's (*swt*) pleasure; and injustice, His displeasure. Whereas justice in Western thought is a quality of the behavior of one individual in relation to another and his actions can be perceived as unjust only in relation to the "other," in Islam it has implications and consequences for the first individual as well. That is, even when one does injustice to someone else, there is always reciprocity, in that through injustice to others, ultimately, one also does injustice to oneself and receives its results both here and in the hereafter.

Justice in Islam is a multifaceted concept, and several words or terms exist for each aspect. The most common word in use, which refers to the overall concept of justice, is the word *adl*. This word and its many synonyms imply the concepts of "right," as an equivalent of "fairness," "putting things in their right place," "equality," "equalizing," "balance," "temperance,"

and “moderation.” These last few concepts are more precisely expressed as the principle of the “golden mean,” according to which believers are not only individually urged to act in conformity with this principle, but also the community is called upon, by the *Qur'an*, to be a “nation in the middle.”<sup>6</sup> Thus, justice in Islam is the conceptualization of an aggregation of moral and social values, which denotes fairness, balance, and temperance. Its implication for individual behavior is, first of all, that the individual should not transgress his bounds and, secondly, that one should give others, as well as oneself, what is due.

In practice, justice is operationally defined as acting in accordance with the Law, which, in turn, contains both substantive and procedural justice. Substantive justice consists of elements of justice contained in the substance of the Law, while procedural justice consists of rules of procedure assuring the attainment of justice contained in the substance of the Law. The underlying principles which govern the distinction between just and unjust acts determine the ultimate purpose of the Islamic path, the *Shari'ah*, which includes: the establishment of the “general good” of society (considered to be the intent of the *Qur'an* for human collectivity and the *Shari'ah* is the path by which it is achieved); building the moral character of individuals; and, finally, the promotion of freedom, equality, and tolerance, which are often stated as important goals of the *Shari'ah*. Of these, protecting the interests of society is accorded the greatest importance. Although there can be no contradiction between justice for the community as a whole and justice for the individual, the interest of the individual is protected so long as such interest does not come into conflict with the general interest of the community.

### ***SHARI'AH—THE LAW***

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Islam legislates for man according to his real nature and the possibilities inherent in the human state. Without overlooking the limited and the weak aspects of human nature in any way, Islam envisages man in light of his primordial nature as a theophany of Allah's attributes, with all the possibilities that this implies. It considers the human as having the possibility of being perfect, but with a tendency to neglect potentialities of the human state by remaining only at a level of sense perception. It asks, therefore, that in exchange for all the blessings provided by their Supreme Creator, humans seek to realize the full potential of their being, and remove all the obstacles which bar the right functioning of their intelligence. To order human life into a pattern intended for it by its Creator, humans are provided with a network of injunctions and rules, which represent the concrete embodiment of the Divine Will in terms of specific codes of behavior, by virtue of acceptance of which—through the exercise of his free choice—a person becomes a Muslim and according to which the individual lives both his private and social life. This network of rules—called the *Shari'ah*, which is etymologically derived from a root meaning “the road”—leads man to a harmonious life here and felicity hereafter.

The emphasis on the axiomatic principle of Unity forms the basis for the fundamental belief that Islam recognizes no distinction between the spiritual and the temporal, between the sacred and the profane, or between the religious and the secular realms. Islam seeks to integrate all human needs, inclinations, and desires through the all-embracing authority of the *Shari'ah*. Life is considered as one and indivisible. Therefore, the rules of the *Shari'ah* hold sway over economic life no less than over social, political, and cultural life; they persuade, determine, and order the whole of life. It is through the acceptance of and compliance with the rules of the *Shari'ah* that individuals integrate themselves not only into the community, but also into a higher order of reality and the spiritual center. Violations of these rules will have a disintegrative effect upon the life of the individual and that of the community.

The *Shari'ah* rules are derived, based on the *Qur'an* and its operationalization by the Prophet (pbuh), through a rigorous process of investigation and thinking across time and geographical regions. The expansion of the rules of Law and their extension to new situations, resulting from the growth and progress of the Islamic community, is accomplished with the help of consensus in the community, analogical reasoning—which derives rules by discerning an analogy between new problems and those existing in the primary sources—and through the independent human reasoning of those specialized in the Law. As a result, *Shari'ah* is invested with great flexibility in handling problems in diverse situations, customs, and societies and therefore has a wide range of solutions and precedents, depending on different circumstances.

History has *not* recorded instances when Muslim jurists were unable to provide Islamic solutions to new problems. Their opinions covered all aspects of life. They laid down brilliant theories, exemplary rules and solutions. Unfortunately, however, with the decline of Islamic rule in Muslim countries, the significance of the *Shari'ah* in running day-to-day life also declined and development of the *Shari'ah* remained dormant. In the last few decades, however, the reawakening among Muslims has generated enormous demand for the development of *Shari'ah*-based rules that address the problems of modern society.

## **BASICS OF THE *SHARI'AH***

The life of a Muslim at the individual and the societal levels is governed by different sets of rules. The first set, known as *aqidah* (faith), concerns the core relationship between people and the Creator and deals with all matters pertaining to a Muslim's faith and beliefs. The second set deals with transforming and manifesting the faith and beliefs into action and daily practices and is formally known as *Shari'ah* (Law). Finally, the third set is *akhlaq*, which cover the behavior, attitude, and work ethics according to which a Muslim lives in society. *Shari'ah*

(Continued)

is further divided into two components: *ibadat* (rituals) focuses on the rites and rituals through which each individual comes to an inner understanding of their relationship with Allah (*swt*); *muamalat*, on the other hand, defines the rules governing social, political, and economic life. Indeed, a significant subset of *muamalat* defines the conduct of economic activities within the economic system, which ultimately lays down the rules for commercial, financial and banking systems.

*Ijtihad* (from the root *jahd*, meaning “struggle”) plays a critical role in deriving rules for resolving issues arising from time-dependent challenges. *Ijtihad* refers to the efforts of individual jurists and scholars to find solutions to problems that arise in the course of the evolution of human societies and that are not addressed specifically in the primary sources. *Ijtihad* is based on the earlier consensus of jurists (*ijma'*), analogy (*qiyas*), judicial preference (*istihsan*), public interest (*maslahah*) and customs (*urf*). Secondary sources of the *Shari'ah* must not introduce any rules that are in conflict with the main tenets of Islam.

Over the course of history, different methods of exercising *ijtihad* have evolved depending upon the historical circumstances and the different schools of thought (*madhahib*) that prevailed at different times. The most commonly practiced methods are Hanafi, Maliki, Shafi'i, Hanbali and Jafari, which each assign different weights in decision-making to each source of Law; that is, the *Qur'an*, the *Sunnah*, *ijma'* and *qiyas*. For example, the Jafari school does not accept analogical reasoning in its entirety as a legitimate method to derive rules of *Shari'ah*, favoring instead the expert investigation and provision of solutions to new problems by jurists.

## **ISLAMIC ECONOMIC AND FINANCIAL SYSTEMS**

Given our understanding of the role of institutions, rules, Law (*Shari'ah*) and the ideology of Islam, we can make the following propositions regarding an Islamic economic system (the core principles of which will be discussed in detail in Chapter 2):

- Islam has a view on how to organize political, social, and economic systems based on a set of ontological and epistemological propositions regarding individuals and their collectivities.
- Defining an economic system as a collection of institutions dealing with production, exchange, distribution and redistribution, and defining institutions as rules and norms, Islam proposes a distinct economic system

that differs in many important respects from those recommended by other schools of thought regarding how an economy is to be organized. To the extent that such an economy can be defined by its distinctive “institutional scaffolding,” it can also be defined as an Islamic economy to distinguish it from other types of economy.

- The behavioral rules and norms of an Islamic system—once clearly, rigorously, and analytically articulated—could yield empirically testable propositions that, in turn, could lead to policy analysis and recommendation on solutions to the problems of modern societies. To the extent that the emergence of a discipline devoted to studying and extracting economic rules of behavior in an Islamic economy is possible, analyzing the actual (as opposed to the ideal) performance of economies, devising incentive structures that promote rule compliance to allow convergence of actual and ideal, and recommending policy actions to accomplish such objectives, that discipline could be called “Islamic economics.” While an ideal Islamic economy is defined by the meta-framework and the archetypal model, Islamic economics would employ the accumulated store of human knowledge, including methods of analysis developed in the field of economics, to find ways and means of stimulating convergence between the actual and the ideal.

Since this book is about Islamic finance, a digression on the relevant basic principles may be helpful. Islam’s unconditional prohibition of *riba* (discussed in detail in Chapter 3) changes the landscape of a financial system. This prohibition implies the prohibition of pure debt security and ultimately of leverage through debt. It is important to note that debts based on a predetermined rate tied to the principal are prohibited. Other modes of financing based on the principle of the sharing of risk and reward are recommended. The elimination of interest and the promotion of risk-sharing modes of financing are the rationale behind Islamic finance practiced today. While acknowledging the expressions of skepticism, and even cynicism, regarding the present practices of Islamic finance, it appears that there is a consensus among an overwhelming majority of scholars on two fundamental propositions: (i) interest is *riba*, and (ii) risk-and-reward sharing is an Islamic alternative to a system based on interest-rate debt.

The notion of having a system that operated without interest and debt came under immediate challenge, with analysts suggesting the folly of adopting such a system. The prohibition of interest would, they argued, result in infinite demand for loanable funds and zero supply. A zero-interest system would be incapable of equilibrating demand for and supply of loanable funds. Such a system would mean that there would be no savings and, thus, no investment and no growth. There could be no monetary policy, they said, since no instruments of liquidity management could exist without a fixed, predetermined rate of interest. Any country adopting such a system could almost guarantee that there would be a one-way capital flight.

## BASIC PRINCIPLES OF AN ISLAMIC FINANCIAL SYSTEM

**Prohibition of interest:** Prohibition of *riba*, a term literally meaning “an excess” and interpreted as “any unjustifiable increase of capital, whether in loans or sales,” is the central tenet of the system. More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principal (that is, guaranteed regardless of the performance of the investment) is considered *riba* and is prohibited. The general consensus among Islamic scholars is that *riba* covers not only usury but also the charging of “interest” as widely practiced. A direct implication of the prohibition of interest is that pure debt securities with predetermined interest rates are also prohibited.

This prohibition is based on arguments of social justice, equality, and property rights. Islam encourages the earning of profits but forbids the charging of interest because profits, determined *ex post*, symbolize successful entrepreneurship and the creation of additional wealth. By contrast, interest, determined *ex ante*, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there are business losses. Social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity.

**Risk sharing:** Because interest is prohibited, pure debt security is eliminated from the system and therefore suppliers of funds become investors, rather than creditors. The provider of financial capital and the entrepreneur share business risks in return for shares of the profits and losses.

**Asset-based:** The prohibition of debt and the encouragement of risk sharing suggest a financial system where there is a direct link between the real and the financial sector. As a result, the system introduces a “materiality” aspect that links financing directly with the underlying asset so that the financing activity is clearly and closely identified with the real-sector activity. There is a strong link between the performance of the asset and the return on the capital used to finance it.

**Money as “potential” capital:** Money is treated as “potential” capital—that is, it becomes actual capital only when it is combined with other resources to undertake a productive activity. Islam recognizes the time value of money, but only when it acts as capital, not when it is “potential” capital.

**Prohibition of speculative behavior:** An Islamic financial system discourages hoarding and prohibits transactions featuring extreme uncertainty, gambling, and risk.

**Sanctity of contracts and the preservation of property rights:** Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard. Islam places great importance on the preservation of property rights, defines a balance between the rights of individuals, society and the state, and strongly prohibits encroachment on anyone's property rights.

By 1988, this challenge was met when academic research, using modern analytical financial and economic theory, showed that:

- A modern financial system can be designed without the need for an *ex ante*, determined, positive, nominal fixed-interest rate. Indeed, it was shown that there was no satisfactory explanation for the existence of such a rate.
- Moreover, it was shown that not having such an interest rate (that is, the absence of a debt contract) did not necessarily mean that there would be zero return on capital.
- The basic proposition of Islamic finance was that the return on capital would be determined *ex post*, and that the magnitude of that return was determined on the basis of the return to the economic activity in which the funds were employed.
- It was the expected return that determined investment.
- It was also the expected rate of return, and income, which determined savings. Therefore, there was no justification for assuming that in such a system there would be no savings and investment.
- It was shown that in such a system **there would be** positive growth.
- Monetary policy in such a system would function as in the conventional system, its efficacy depending on the availability of instruments designed to manage liquidity.
- Finally, it was shown that, in an open-economy macroeconomic model without an *ex ante* fixed-interest rate, but with returns to investment determined *ex post*, there was no justification to assume that there would be a one-way capital flight.

Therefore, the system which prohibited a fixed *ex ante* interest rate and allowed the rate of return on capital to be determined *ex post*, based on the returns to the economic activity in which the funds were employed, was theoretically viable.

In demonstrating the analytical viability of such a system, the research also clearly differentiated it from the conventional system in which, based on debt contracts, risks and rewards were shared asymmetrically, with the

debtor carrying the greatest part of the risk, and with governments enforcing the contract. Such a system had a built-in incentive structure that promoted a moral hazard and asymmetric information and thus required close monitoring. The costs could be managed if monitoring could be delegated to an institution that could act on behalf of the collectivity of depositors/investors; hence the existence of banking institutions.

In the late 1970s–early 1980s, Minsky and others demonstrated that such a system was inherently prone to instability because there would always be a maturity mismatch between liabilities (short-term deposits) and assets (long-term investments). Because the nominal values of liabilities were guaranteed, but the nominal values of assets were not, when the maturity mismatch became a problem, banks would attempt to manage their liabilities by offering higher interest rates to attract more deposits. There was always the possibility that this process would not be sustainable, resulting in an erosion in confidence and runs on banks. Such a system, therefore, needed a lender of last resort and bankruptcy procedures, restructuring processes, and debt-workout procedures to mitigate the contagion.

During the 1950s–60s, Lloyd Metzler of the University of Chicago had proposed an alternative system in which contracts were based on equity rather than debt, and in which there was no guarantee of nominal values of liabilities since these were tied to the nominal values of assets. Metzler showed that such a system did not have the instability characteristic of the conventional banking system. In his now-classic article, Mohsin Khan (1987) showed the affinity of Metzler’s model with Islamic finance. Using Metzler’s basic model, Khan demonstrated that this system produces a saddle point and is, therefore, more stable than the conventional system.

By the early 1990s, it was clear that an Islamic financial system was not only theoretically viable, but also had desirable characteristics that rendered it superior to a debt-based conventional system. The phenomenal growth of Islamic finance during the decade of the 1990s demonstrated the empirical and practical viability of the system.

The crises we have been witnessing in the international financial system since 1997 have set the stage for Islamic finance to demonstrate its viability as potentially a genuine alternative global financial system. The present international system is deficient in many ways, of which the two most important are:

- A debt-based system needs an effective lender of last resort, and the present international financial system does not have one and it is not likely that one will emerge anytime soon; and
- A debt-based system needs bankruptcy proceedings, debt restructuring, and workout mechanisms and processes that the present international financial system lacks. There are preliminary discussions under way for an international sovereign-debt restructuring mechanism to be established, but there are many complications. While such a mechanism,



if and when it comes into being, will help reduce the risk of moral hazard and lead to a better distribution of risk, it will not address the inherent and fundamental fragility of a system based largely on debt contracts.

The financial crisis of 2007–2009 reinforced and exposed many of the inherent vulnerabilities of a debt-based system: excessive leverage, failure of market discipline, complex derivatives remote from real economic transactions, and lapses of corporate governance. Askari *et al.* (2010) examined the crisis and have argued that an Islamic financial system would be more stable when followed in its essence.

## **MODERN HISTORY OF ISLAMIC BANKING AND FINANCIAL SERVICES**

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Although Islam has provided a blueprint of how a society is to be organized and how the affairs of its members are to be conducted in accordance with its prescriptions, with the exception of a brief period following its inception the system itself has not been applied in its entirety. The economy at that time was, of course, much less complex than the economies of modern times. The business practices of the day conformed to the principles of Islam and the element of “interest” was minimized. Indeed, the practice of interest was also condemned by other major religions and the institution of interest had yet to be developed. It is only in recent decades, when the element of interest became an integral part of economic life, that Muslims have been forced to become more conscious of its existence at a time of growing interest in the wider implementation of Islamic teachings.

It is for this reason that our discussion on the history of Islamic economics and finance is limited to developments since the nineteenth century. These developments towards implementing a *Shari’ah*-compliant economic, financial, and banking system can be divided into three phases.

### **Phase I: Pre-1960**

Throughout the nineteenth century and through a good part of the twentieth century, several Muslim countries were under colonial rule. During the colonial period, these Muslim societies to varying degrees lost touch with their old traditions, values and cultural heritage. Although there is evidence of resistance to the imposition of colonial values and a desire to return to the Islamic tradition, such efforts were not widespread. It was only after the end of the colonial period that Muslims began to re-discover their identities and manifested the desire to regain the lost values in all aspects of life, especially in the economic sphere.

Siddiqi (2006: 2) recalls conducting a survey of writings on Islamic economics and banking in English, Arabic, and Urdu languages in the early 1970s, and makes the following observations:

*Out of the items included in the bibliography only eight date before 1920. Out of these, only two deal with the subject of interest, the remaining dealing with distribution of wealth (2) history (2) trade (1) and waqf (1). Of the 14 entries in the following decade only one deals with interest, the remaining are spread over other subjects. The first writings on interest-free banking appear in the nineteen forties. Out of a total of 28 writings on Islamic economics during this period, three are on interest-free banking. Among the remaining, zakat and the Islamic economic system in general has the largest number of writings. Though the writers in this period include Ulema [scholars] trained in traditional schools, the writings on interest-free institutions are not by them. We have 156 entries for the nineteen-fifties which include several writings on interest and interest-free institutions but the writings on socialism, capitalism and on some other aspects of Islamic economy far outnumber these.*

A formal critique and opposition to the element of interest started in Egypt in the late nineteenth century when Barclays Bank was established in Cairo to raise funds for the construction of the Suez Canal. The establishment of such an interest-based bank in a Muslim country attracted opposition from its inception. Further, a formal opposition to the institution of interest can be found as early as 1903 when the payment of interest on post office savings funds was declared contrary to Islamic values, and therefore illegal, by *Shari'ah* scholars in Egypt. In India, a minority community of Muslims in southern India took the first step toward their desire to pursue an Islamic mode of economic activities by establishing interest-free loans as early as the 1890s. This was mainly a welfare association collecting donations and animal skins from the public to provide interest-free loans to the poor. An interest-free credit society was also established in Hyderabad in 1923.

During the first half of the twentieth century, there were several attempts to highlight the areas in which the emerging conventional economic system conflicted with Islamic values. The need for an alternative economic system conforming to the principles of Islam soon came to the fore and economists began to explore *Shari'ah*-compliant contracts, especially equity partnerships. Some of the early Muslim intellectuals and jurists (*fuqaha*) who made significant contributions in developing alternatives based on the tenets of Islam include Maulana Syed Abul Ala Maudoodi (Pakistan), Imam Muhammad Baqir al-Sadr (Iraq), Anwar Iqbal Qureshi (Pakistan), Mohammad Nejatullah Siddiqi (India), Muhammad Uzair (Saudi Arabia), Umer Chapra

(Saudi Arabia), and Ahmad al-Najjar (Egypt).<sup>7</sup> By 1953, Islamic economists had offered the first description of an interest-free bank on a two-tier *mudharabah* and *wakala* (agency) basis. By the end of the 1950s, Islamic scholars and economists had begun to offer theoretical models of financial intermediation as a substitute to interest-based banking.

## Phase II: 1960s–1980s

By the start of the 1960s, the demand for *Shari'ah*-compliant banking was such that it resulted in the establishment of the *Mit Ghamr* Local Savings Bank in Egypt in 1963 by the noted social activist Ahmad al-Najjar. This is widely considered to be the first modern Islamic bank.

It is worth noting that Dr. Najjar chose to promote this institution as a social welfare institution rather than as an Islamic bank.<sup>8</sup> His bank, based on the principle of rural banking within the general framework of Islamic values, borrowed some ideas from German savings banks. Unfortunately, this experiment lasted just four years. Around the same time, there were parallel efforts in Malaysia to develop a scheme that would enable Muslims to save money to perform the Pilgrimage without the contamination of interest that regular commercial banks were charging. The Pilgrims' Savings Corporation was established in 1963 and was later incorporated into the Pilgrims' Management and Fund Board (popularly known as *Tabung Haji*) in 1969.

The Nasir Social Bank in Egypt, established by presidential decree in 1971, was the first state-sponsored interest-free institution. The establishment of the Dubai Islamic Bank in the UAE in 1975 is considered to be one of the earliest private initiatives. The rapid accumulation of revenues ("petro-dollars") in several oil-rich Muslim countries in the Middle East in the 1970s offered strong incentives for creating suitable investment outlets for Muslims wanting to comply with the *Shari'ah*. This business opportunity was exploited by both domestic and international bankers, including some of the leading conventional banks.

In 1975, the Islamic Development Bank (IDB) was established on the lines of regional development institutions with the objective of promoting economic development in Muslim countries as well as offering *Shari'ah*-compliant development finance. The Jeddah-based IDB has played a key role in expanding Islamic modes of financing and in undertaking valuable research in the area of Islamic economics, finance and banking. During the 1970s, the concept of a financial *murabahah* (trust financing) was developed as the core mechanism for the placement of Islamic banks' funds. Academic and research activities were launched with the First International Conference on Islamic Economics, held in Mecca, Saudi Arabia, in 1976. The first specialized research institution, the Centre for Research in Islamic Economics, was established at the King Abdul Aziz University of Jeddah, Saudi Arabia, in 1978.

The 1980s marked the beginning of a trend of rapid growth and expansion for the emerging Islamic financial services industry that continued through the 1990s. During that period, the Islamic Republics of Iran, Pakistan and Sudan announced their intentions to transform their overall financial systems to make them compliant with the *Shari'ah*. Other countries such as Malaysia and Bahrain instituted Islamic banking within the framework of their existing systems. The International Monetary Fund (IMF) initiated research in the macroeconomic implications of an economic system operating without the basis of interest. Similar research was conducted into the financial stability of a system based on the sharing of profit and loss. The significance and contribution of this research was recognized in 2004 when two IMF economists were awarded IDB's highest prize in Islamic economics.<sup>9</sup> The Organization of Islamic Countries (OIC) Fiqh Academy and other *Shari'ah* scholars became engaged in the discussions for reviewing financial transactions.

During the early stages of the Islamic financial market, Islamic banks faced a dearth of quality investment opportunities, which created business opportunities for the conventional Western banks to act as intermediaries to deploy Islamic banks' funds in accordance with guidelines provided by the Islamic banks. Western banks helped Islamic banks place funds in commerce and trade-related activities by arranging a trader to buy goods on behalf of the Islamic bank and to resell them at a mark-up. Gradually, Western banks realized the importance of the emerging Islamic financial markets and began to offer their own Islamic products through "Islamic windows" in an attempt to attract the clients directly. Islamic windows are not independent financial institutions, but are specialized set-ups within conventional financial institutions that offer *Shari'ah*-compliant products for their clients. Meanwhile, driven by the growing demand for *Shari'ah*-compliant products and fear of losing depositors, non-Western conventional banks also started to offer Islamic windows. In general, these windows are targeted at high-net-worth individuals who want to practice Islamic banking—that is, approximately 1–2 percent of the world's Muslims.

### **Phase III: 1990s–Present**

By the early 1990s, the market had gained enough momentum to attract the attention of policymakers and institutions interested in introducing innovative products. Recognizing the need for standards, a self-regulatory agency—the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)—was established. This was instrumental in highlighting the special regulatory needs of Islamic financial institutions and in defining accounting and *Shari'ah* standards, which were adopted or recognized by several countries. However, with the growth of the market, the regulatory and supervisory authorities, with the help of the IMF, established a dedicated regulatory agency, the Islamic Financial Services Board (IFSB) in the early

2000s to address systemic stability and various governance and regulatory issues relating to the industry.

Further progress was made in developing capital markets. Islamic asset-backed certificates, *sukuks*, were launched successfully in Bahrain, Malaysia and other financial centers. Among the issuers were corporations, multilaterals and sovereign entities such as the Islamic Development Bank, the International Bank for Reconstruction and Development and the Governments of Bahrain, Qatar and the Islamic Republic of Pakistan. During the equities market boom of the 1990s, several equity funds based on *Shari'ah*-compatible stocks emerged. The Dow Jones and *Financial Times* launched Islamic indices to track the performance of Islamic equity funds.

The number of conventional banks offering Islamic windows grew. Citibank was one of the early Western banks to establish a separate Islamic bank—Citi Islamic Investment Bank (Bahrain) in 1996—and the Hong Kong and Shanghai Banking Corporation (HSBC) now has a well-established network of banks in the Muslim world. With the objective of promoting Islamic asset securitization and private equity and banking in OECD countries, HSBC Global Islamic Finance (GIF) was launched in 1998. The list of Western banks keeping Islamic windows includes the American Express Bank Ltd., ANZ Grindlays, BNP-Paribas, Deutsche Bank UBS, and Kleinwort Benson. The leading non-Western banks with significant Islamic windows are National Commercial Bank of Saudi Arabia, United Bank of Kuwait, and Riyadh Bank.

Several institutions were established to create and support a robust financial system. These institutions include the International Islamic Financial Market (IIFM), the International Islamic Rating Agency (IIRA), the General Council of Islamic Banks and Financial Institutions (CIBAFI) and the Arbitration and Reconciliation Centre for Islamic Financial Institutions (ARCIFI).

Islamic finance has begun to go global. Although Western financial centers and financial intermediaries have always played an important part in executing and innovating Islamic transactions, such activities have been mostly carried in the private sector and in a discreet fashion. By early 2000, this trend had begun to change, with several non-Muslim countries taking an interest in this emerging financial market. This can be attributed to several factors such as booming oil revenues leading to accumulation of investible funds looking for attractive investment opportunities; an increased awareness of regulatory issues relating to Islamic financial intermediaries; and the desire to tap into alternative funding resources by sovereign and corporate entities.

Islamic finance has had a long, if silent, presence in Europe. A major early development was the establishment in 1981 of the Dar al Maal al Islami Trust in Geneva, an investment company that held stakes in several Islamic banks.<sup>10</sup> Many high-net-worth clients demanding *Shari'ah*-compliant investments deal directly with European banks, notably with UBS of Switzerland, the leading provider of *Shari'ah*-compliant wealth-management services.

The German Federal State of Saxony-Anhalt pioneered the *sukuk* in Europe with a five-year offering which raised €100 million (US\$120 million) in July 2004.<sup>11</sup> Although London has been active in the market, the idea of Islamic finance has yet to attract attention on a large scale elsewhere in Europe. In France, for example, where the Muslim population of six million is three times that of the UK, the authorities and regulators have been slow to realize the potential of this market.<sup>12</sup>

During the period 2005–2008, there was another wave of interest in Islamic finance, again prompted by increased oil revenues in the Middle East. However, unlike the surge in the 1970s which was limited to the high-net-worth class, the current growth is the result of demand from a much wider group that includes small investors and retail consumers. Several countries where Islamic finance was dormant are experiencing a sudden surge in demand for *Shari'ah*-compliant products. In Saudi Arabia, for example, such has been the public pressure to embrace Islamic finance that the country's largest bank, the National Commercial Bank, has converted its entire branch network to *Shari'ah* principles.<sup>13</sup> Bahrain and Malaysia have also taken an active role in the development of Islamic finance and have made serious efforts to establish world-class financial centers to promote Islamic finance.

London's historical reputation and significance as a financial center, coupled with its attractiveness as a time-zone with respect to the Middle East, has made it a popular choice for Islamic financial transactions. It is said that more money from the most widely used Islamic financial instrument, the commodity *murabahah*, flows through London financial center than in any other center.<sup>14</sup> With a Muslim population of almost two million in the UK, there was sufficient demand to establish the Islamic Bank of Britain in September 2004. By the end of 2006, this had attracted deposits worth £83 million (US\$165 million) from 30,000 customers and its assets stood at £120 million (US\$240 million).<sup>15</sup> Similarly, the European Islamic Investment Bank (EIIB) began its operations in April 2006 with the objective of promoting *Shari'ah*-compliant investment banking. In 2008, the European Finance House (EFH), a unit of Qatar Islamic Bank, was awarded a banking license in the UK to provide *Shari'ah*-compliant banking. EFH plans to target the European Union's 14 million Muslims who will have access to Islamic financial products.<sup>16</sup>

Realizing the significance and potential for Islamic finance domestically and internationally, the UK government has taken steps to make its markets "Islamic Finance Friendly." In 2007, for example, it began to explore the possibilities for launching a sovereign *sukuk* designed to encourage the domestic Islamic financial market and develop a global benchmark. In the budget that year, *sukuk* were accorded the same tax status as conventional debt instruments and the income to *sukuk* investors was treated as interest income. These measures were introduced to send positive signals to potential *sukuk* investors and to ensure a level playing field with

conventional securities. As more steps are taken to develop London as a hub for Islamic finance, it poses serious threats for regional financial centers such as Bahrain and Malaysia. Some argue that this may lead to capital flight, which can hamper the development of the regional centers. However, others argue that London can play a complementary and enhancing role through providing financial innovations, cost-effective execution and access to other markets.

The presence of Islamic finance is beginning to be felt all over the globe and multilateral institutions are also engaging with the market. The World Bank and the IMF have made contributions to this field through research, and other institutions are also getting involved. The International Finance Corporation (IFC)—the private-sector arm of the World Bank—has executed several *Shari'ah*-compliant transactions. In 2009, IFC issued *sukuk* to the value of US\$100 million for funding Islamic finance projects in key sectors such as health, education, and infrastructure in the Middle East. In 2007, the World Bank-affiliated Multilateral Investment Guarantee Agency (MIGA) provided its first-ever guarantee for *Shari'ah*-compliant project financing, worth US\$427 million.<sup>17</sup>

The major developments in modern Islamic economics and finance are summarized in Table 1.1.

## **Institutional Development**

The private sector has been much more active than the public sector in the growth of this market. Governments such as those of Bahrain and Malaysia have made serious efforts to establish centers for Islamic financial institutions and the institutional infrastructure to support development of the financial sector is slowly emerging. This includes institutions to deal with accounting and regulatory standards, corporate governance, credit ratings, and capital markets. These efforts to develop institutions are also supported by several stakeholders such as the IMF, central banks of leading Muslim countries, international standard-setting bodies, and financial centers.

As mentioned earlier, the IDB was established in 1975 as a regional development institution to promote economic development in Muslim countries through Islamic finance. Since then, it has established several sister institutions to develop the private sector, insurance facilities, and trade and export financing.<sup>18</sup>

The Islamic Research and Training Institute (IRTI)—the IDB's research arm—was established in 1981 to undertake research and training in a range of economic, financial and banking issues. It has become a rich resource center for, and has played a critical role in, developing a 10-year master plan for the Islamic financial industry.

The Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), another of the IDB's sister organizations, was established in

**TABLE 1.1** Developments in modern Islamic economics and finance

Pre-1950s	Barclays Bank opens its Cairo branch in the 1890s to process the financial transactions related to the construction of the Suez Canal. Islamic scholars challenge the operations of the bank, considering its dealings to involve interest. This critique also spreads to other Arab regions, and to the Indian sub-continent where there was a sizeable Muslim community. Majority of <i>Shari'ah</i> scholars declare that interest in all its forms amounts to the prohibited element of <i>riba</i> .
1950s–60s	Initial theoretical work in Islamic economics begins. In 1953, Islamic economists offer the first description of an interest-free bank based either on two-tier <i>mudaraba</i> or <i>wakala</i> . Mit Ghamr Bank in Egypt and Pilgrimage Fund in Malaysia start.
1970s	First Islamic commercial bank, Dubai Islamic Bank, opens in 1974. Islamic Development Bank (IDB) is established in 1975. Accumulation of oil revenues and petro-dollars increases demand for <i>Shari'ah</i> -compliant products.
The 1980s	Islamization of economies in Islamic Republics of Iran, Pakistan and Sudan, which introduce interest-free banking systems. Increased demand attracts Western intermediation and institutions. The IDB establishes the Islamic Research and Training Institute (IRTI) in 1981. Countries like Bahrain and Malaysia promote Islamic banking parallel to the conventional banking system.
The 1990s	Attention is paid to the need for accounting standards and regulatory framework. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is established. Islamic insurance ( <i>takaful</i> ) is introduced. Islamic Equity Funds are established. Dow Jones Islamic Index and FTSE Index of <i>Shari'ah</i> -compatible stocks are developed.
2000–Present	The Islamic Financial Services Board (IFSB) is established to deal with regulatory, supervisory and corporate-governance issues. <i>Sukuks</i> (Islamic bonds) are launched. Globalization of Islamic finance as <i>Shari'ah</i> -compliant transaction starts to appear in Europe, Asia and North America. Growth of academic interest and research followed by offering of organized programs at reputable Western universities. Limited application of financial engineering through introduction of profit-rate swaps. Legal issues are raised in cross-border jurisdictions after defaults on <i>Shari'ah</i> -compliant transactions during and after the financial crisis.

Sources: Khan (1996), IDB (2005), and Iqbal and Mirakhor (2007).



1994 with the objective of enlarging the scope of trade transactions and the flow of investments among member countries. The ICIEC's main objectives are to provide *Shari'ah*-compliant export credit insurance and reinsurance to cover the non-payment of export receivables resulting from commercial (buyer) and non-commercial (country) risks and to provide investment insurance and reinsurance against country risk, emanating mainly from foreign-exchange transfer restrictions, expropriation, war and civil disturbance, and breach of contract by the host government. The Islamic Corporation for the Development of the Private Sector (ICD) was established in 1999 to promote the development of the private sector in member countries. Its objectives are to (i) identify opportunities in the private sector that could function as engines of growth; (ii) provide a wide range of productive financial products and services; (iii) mobilize additional resources for the private sector in member countries, and (iv) encourage the development of Islamic financial and capital markets.

In 2006, the IDB established the International Islamic Trade Finance Corporation (ITFC) to promote trade among OIC countries by providing *Shari'ah*-compliant trade finance, promoting trade among member countries, enhancing their export capabilities and increasing the developmental impact of trade financing in those countries. That same year, IDB members also established a special "solidarity" fund for reducing poverty, eliminating illiteracy, eradicating major communicable diseases and building the human and productive capacities, particularly in the least-developed OIC countries. This fund is organized as an endowment (*waqf*) fund, with targeted capital of US\$10 billion.

The AAOIFI was established as a self-regulatory agency to tackle the problem of *Shari'ah* compliance and gaps in applying conventional financial reporting standards to Islamic banks. Its membership consists of some 97 institutions spanning more than 24 countries and its *Shari'ah* Board is paving the way towards harmonizing Islamic banking practices throughout the world.<sup>19</sup> A number of countries, including Bahrain and Sudan, either require Islamic banks to comply with AAOIFI standards or, as in the case of Qatar and Saudi Arabia, are specifying AAOIFI standards as guidelines.

The AAOIFI was successful in defining accounting and *Shari'ah* standards, which were adopted or recognized by several countries. However, with the growth of the market, in 2000 the regulatory and supervisory authorities established, with the help of the IMF, a dedicated regulatory agency, the Islamic Financial Services Board (IFSB), to address systemic stability and various governance and regulatory issues relating to the Islamic financial services industry. The IFSB took on the challenge and started working in the areas of regulation, risk management and corporate governance, which are discussed in more detail later.

Table 1.2 sets out the functions of many of the key organizations now operating in the field of international Islamic finance.

The General Council of Islamic Banks and Financial Institutions (GCIBFI) focuses on the media and awareness, information and research, policies

**TABLE 1.2** Key institutions in the Islamic financial industry

Acronym	Organization	Function
IDB	Islamic Development Bank	Development institution developed in 1975 to promote Islamic finance and economic development Member/Sister Organizations ICD: Islamic Corporation for the Development of the Private Sector ICIEC: Islamic Insurance Company, providing insurance products for investments and export credits IRTI: Research and training arm of IDB ITFC: International Islamic Trade Finance Corporation Solidarity Fund: To reduce poverty in OIC countries ARCIFI: Arbitration and Reconciliation Center for Islamic Financial Institutions
AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions	Accounting and <i>Shari'ah</i> standard-setting body
IFSB	Islamic Financial Services Board	Standard-setting institution to ensure best practices and help member countries with regulating Islamic financial institutions
IIFM	International Islamic Financial Markets	Trade association to promote capital markets
IIRA	Islamic International Rating Agency	Rating agency
LMC	Liquidity Management Center	Institution to provide liquidity enhancement to the financial system
CIBAFI	General Council of Islamic Banks and Financial Institutions	Trade association of Islamic banks to enhance member institutions' ability to better serve customers around the world through transparent banking practices

and strategic planning, and Islamic financial products. The Arbitration and Reconciliation Centre for Islamic Financial Institutions (ARCIFI) aims to settle, through reconciliation and arbitration, financial and commercial disputes involving institutions that have chosen to comply with the *Shari'ah* to settle disputes.

The major objectives of the Bahrain-based IIFM are (a) to enhance cooperation among regulatory authorities of Islamic banks, (b) to address the liquidity problem by expanding the maturity structure of instruments, and (c) to explore the possibility of sovereign asset-backed securities. The IIFM is currently working with the International Capital Markets Association (ICMA) on the further development of primary and secondary markets for Islamic bonds (*sukuk*). The two groups are working together to develop a repurchase (repo) master agreement to help central banks manage liquidity in the *sukuk* market; as well as a master agreement for *murabahah* commodities contracts, which are used in interbank transactions between Islamic banks and between Islamic and conventional banks.<sup>20</sup>

The IIRA aims to assist in the development of regional financial markets by providing an assessment of the risk profile of entities and instruments that can be used for investment decisions. The IIRA is sponsored by multilateral finance institutions, several leading banks and other financial institutions, and rating agencies from different countries. The organization has a board of directors and an independent rating committee as well as a *Shari'ah* board. The IIRA also provides a unique service of rating the level of compliance financial institutions have with the stipulations adopted by their *Shari'ah* committee in good faith, both in letter and in spirit. They also examine whether there is a mechanism within the institution to evaluate its compliance with the *Shari'ah* and whether the *Shari'ah* committee has enough authority, information, and resources to perform the examination and evaluation.

The Liquidity Management Center (LMC) was established to facilitate investment of the surplus funds of Islamic banks and financial institutions into quality short- and medium-term financial instruments structured in accordance with *Shari'ah* principles. Its shareholders include Bahrain Islamic Bank, Dubai Islamic Bank, Islamic Development Bank, and Kuwait Finance House. The LMC assists Islamic financial institutions in managing their short-term liquidity and supports the interbank market. In addition, the center attracts assets from governments, financial institutions, and corporations in both the private and public sectors in many countries. The assets are securitized into readily transferable securities or structured into other innovative investment instruments. The Center also provides short-term liquid, tradable, asset-backed treasury instruments (*sukuk*) in which financial institutions can invest their surplus liquidity and offers advisory services dealing with structured, project, and corporate finance as well as equity floatation.

## RECENT TRENDS IN ISLAMIC FINANCIAL MARKETS

There is no formal or systematic source of statistics on Islamic finance but several estimates are often quoted by different commercial and non-commercial sources.<sup>21</sup> According to the 10-Year Master Plan for Islamic Financial Industry prepared by the IDB and IFSB, by the end of 2005, more than 300 institutions in over 65 jurisdictions were engaged in Islamic finance. In a broad sense, the Islamic financial industry consists of a number of components such as Islamic banks, Islamic windows, capital markets, Islamic insurance (*takaful*) and other non-bank financial institutions. Islamic banking usually refers to offshore and onshore deposit-taking commercial and investment banking and is the most dominant sector of the market. Islamic windows are specialized windows available through conventional banks catering to the demands of Islamic products. Historically, Islamic banking and windows have been the most active sector but in the last decade other forms of financial products and services have been gaining momentum. Activities in the capital markets in the form of Islamic funds or Islamic bonds (*sukuk*) are increasing and there are institutions specializing in asset management, mutual funds, and brokerage houses. Islamic non-bank financial institutions, which include specialized institutions offering financial services through leasing (*ijarah*) or partnership (*mudharabah*), perform a similar function to conventional fund-management companies. There is a limited but growing number of institutions engaged in micro-finance, venture capital and private equity financing.

Table 1.3 shows the total size of different segments of the market, compiled from different sources. Given the lack of transparency in financial disclosure by financial institutions in developing countries, these estimates are, if anything, on the conservative side, and the actual size of assets under management is likely to be significantly higher.

Islamic banks have experienced high growth, as shown in Table 1.4 which lists growth rates of assets and deposits in selected countries in the Middle East and North Africa (MENA) region. From this, it is clear that

**TABLE 1.3** Total assets under management as of 2010

Sector	Amount (US\$ billion)
Islamic banks	400
Islamic windows	250
<i>Sukuk</i>	120
Islamic funds	45
<i>Takaful</i>	5
Total	820

Source: IFIS and other estimates

**TABLE 1.4** Growth rates of assets and deposits across countries

Country	Banks in Sample	Assets		Customer Deposits	
		Growth Rate (%)		Growth Rate (%)	
		2006–07	2007–08	2006–07	2007–08
Bahrain	12	48.54	39.00	58.33	32.07
Egypt	2	21.27	10.53	22.89	9.54
Jordan	2	(9.30)	25.86	(8.59)	16.34
Kuwait	2	47.04	19.33	51.05	24.94
Lebanon	1	362.09	145.54	(3.02)	21.43
Qatar	2	34.64	47.94	26.63	31.98
Saudi Arabia	3	23.16	27.94	28.65	22.32
UAE	5	40.28	17.07	46.16	19.56
Yemen	1	7.29	20.08	6.13	18.73
MENA Region	30	34.50	24.50	37.47	22.28

Source: Ali, Syed Salman (2011), *Islamic Banking in the MENA Region*, Washington, DC, USA. [http://siteresources.worldbank.org/INTMNAREGTOPPOVRED/Resources/MENAFlagshipIslamicFinance2\\_24\\_11.pdf](http://siteresources.worldbank.org/INTMNAREGTOPPOVRED/Resources/MENAFlagshipIslamicFinance2_24_11.pdf)

the growth rate was high during the 2006–2007 and 2007–2008 period but there were signs of a slowdown after that. This can be attributed to economic slowdown after the financial crisis.

In general, the trend is that competition is increasing for Islamic banks, as conventional banks are also pursuing this business aggressively. Several Islamic banks that once enjoyed a virtual monopoly in the market are now threatened by conventional banks that may have better marketing networks, name recognition, and economies of scale. For example, according to some estimates, Islamic banks accounted for 71 percent of Islamic assets in 2008 as compared with the almost-100 percent share recorded in 2003.<sup>22</sup>

During the subprime financial crisis, Islamic banks were largely immune because they did not have any investments in toxic debt-based assets. However, Islamic banks were not insulated from the regional economic slowdown arising from the global economic recession. It was observed that, during the first half of 2009, banking assets in the GCC countries declined by 1.1 percent, while assets of the five largest Islamic banks increased by 1.3 percent. This compares with a rise of 17 percent and 21.5 percent, respectively, in 2008.<sup>23</sup>

With the economic recession, concerns have grown with respect to the quality of assets of Islamic financial institutions for several reasons. First,

Islamic banks had considerable investments in the real-estate sector and as result of the decline in property prices and values the market value of assets has deteriorated. Second, Islamic banks tend to have geographical and sectoral concentrations, which has exposed them to additional risk. It is expected that because of prudent practices such as holding excessive liquidity and adequate equity capital, Islamic banks will weather this storm and will continue to grow their assets and deposits base.

Islamic capital markets which grew rapidly were also impacted by the financial crisis. This is evident from the drop in the issuance of Islamic bonds (*sukuk*) in the post-crisis period. There were also several cases of legal disputes concerning *sukuk* which sent negative signals in the market and put downward pressure on demand. However, as legal issues were sorted out in orderly fashion, the market has seen a rebound in demand. For example, the *sukuk* issued by the IDB in 2010 was well received in the market and its demand exceeded the amount offered.

Finally, in another positive move, several central banks signed an agreement in October 2010 to establish a liquidity facility for Islamic financial institutions with the objective of providing liquidity-enhancing products in the market and to offer liquidity through trading short-term financial instruments.

## ENDNOTES

1. For example, see Kuran (1995).
2. Chapra (2000).
3. The term (*swt*) is an abbreviation of *subhana-wa-ta'ala*, meaning "The Exalted One."
4. The verses emphasizing the principle of unity include: "And indeed this is my straight path therefore follow it—and do not follow other ways because that will lead to disunity amongst you" (6:153) "Grab hold of the rope of Allah collectively and do not disunite" (3:103) "Cooperate with one another unto righteousness and piety and do not cooperate with one another unto unrighteousness and enmity" (5:2).
5. The abbreviation "pbuh" ("peace be upon him") invokes the peace and blessings of Allah (*swt*) on the Prophet, and is a sign of respect.
6. *Qur'an* 2:143.
7. Khurshid (2009).
8. Martin (2007).
9. The IDB award for distinguished achievement in Islamic economics was awarded to Dr. Mohsin Khan and Dr. Abbas Mirakhor.
10. Wilson (2007).
11. Ibid.
12. Oakley, David, "Capital Takes a Leading Role," FT Report—Islamic Finance, May 23, 2007, *Financial Times* (London, UK).
13. RedMoney 2007.

14. Oakley, David, "Capital Takes a Leading Role," FT Report—Islamic Finance, May 23, 2007, *Financial Times* (London, UK).
15. Martin, op. cit.
16. *Financial Times*, February 5, 2008.
17. [http://www.miga.org/news/index\\_sv.cfm?aid=1696](http://www.miga.org/news/index_sv.cfm?aid=1696)
18. For further details, see IDB (2005).
19. Alchaar (2006).
20. Kerr, Simon, *Financial Times* reports: Islamic Finance, May 24, 2007.
21. CIBAFI is making efforts to maintain statistics on Islamic financial institutions.
22. S&P Outlook (2010).
23. Ibid.

## CHAPTER 2

# The Economic System

**A**t the core of the Islamic economic system lies a body of immutable rules, defined by the principles of *Shari'ah*, which affect economic behavior and outcomes and which are both time-and-place-invariant. On the periphery of the system, there are rules which have an impact on economic behavior, but which are subject to change depending on the circumstances. These latter are results of decisions taken by legitimate authorities in an Islamic society in pursuit of policies—for example, deliberate interventions in economic affairs—to further their aims. These policies and actions taken in pursuit of specific objectives must, nonetheless, be *Shari'ah*-compatible. While Islamic economic systems adopted in various localities may vary with respect to these peripheral economic rules and institutions, they cannot differ with respect to their core rules and institutions. For example, while one Islamic country may differ from another with respect to its foreign trade policies, there can be no such differences in, say, the institution of inheritance in those countries.

To understand the economic system of Islam, we need to discuss some of its key characteristics. Before that, however, a general statement regarding the Islamic economy is necessary. It can be stated categorically that Islam requires, as one of its specific objectives, a healthy, dynamic, and growth-oriented economy, without which the higher aims of Islam cannot be accomplished. A dynamic and growing economy is considered healthy only when its rules, institutions, organizations and their operations, as well as the behavior of the individual and the collectivity, are in conformity with the *Shari'ah*.

An economic system is a collection of institutions set up by society to deal with the allocation of resources, production and goods and services, and the distribution of the resulting income and wealth. This applies equally to Islam, with a single, major, exception, which simply requires that the word “society” is replaced by the words “the Law-Giver.” Thus, a definition for an Islamic economic system would be along the following lines:

*A collection of institutions (that is, formal and informal rules of conduct and their enforcement characteristics) designed by the Law-Giver (that is, Allah (swt) through the rules prescribed*



*in the Qur'an, operationalized by the sunnah of the Prophet (pbuh) and extended to new situations by ijtihad) to deal with allocation of scarce resources, production and the exchange of goods and services and the distribution of the resulting income and wealth.*

## **INSTITUTIONAL PERSPECTIVE OF ISLAMIC ECONOMICS**

The collection of the rules of behavior prescribed for individuals and collectivities in a given society constitute the institutional structure of that society and define the overall system to which the society adheres. The rules of behavior—whether enshrined in instruments such as social contracts, constitutions and legal framework, or embedded in social conventions, customs, habits and cultural values—are sustained by enforcement mechanisms that provide proper incentives of rewarding compliance with and punishing violations of the rules. The incentive structure must be such that the rules of behavior become self-enforcing or, where this is not possible, that effective mechanisms (the courts, police, ombudsmen, and so on) are in place to enable them to be enforced appropriately.

The institutional framework of the ideal economy is composed of a collection of institutions—rules of conduct and their enforcement characteristics—designed by the Law Giver, prescribed in the meta-framework and operationalized by the archetype model (as outlined in Chapter 1) to deal with allocation of resources, and so on. The objective of these institutions is to achieve social justice (*qist*).

### **Rules of Conduct as "Institutions"**

Rules of behavior are designed to accomplish three objectives: (a) to reduce the cognitive demand on individuals in the face of uncertainty; (b) to specify acceptable and unacceptable behavior; and (c) to make actions by individuals predictable. Together, they reduce uncertainty by making the response of individuals to states of nature in their environment predictable.

Rules specify what kind of conduct is most appropriate to achieving just results when individuals face alternative choices and must take action. They impose restrictions on what society's members can do without upsetting the social order on whose existence all members count in deciding on their own actions and forming their expectations of others' responses and actions. Compliance with the rules determines the degree of certainty in the formation of these expectations, prevents conflict, reconciles differences, coordinates actions, facilitates cooperation, promotes social integration and social solidarity, and strengthens the social order.

To obtain these results, two conditions must exist; one is necessary and the other sufficient. The former requires that rule compliance is enforced,

through persuasion if possible, coercion if necessary. The sufficient condition requires that the rules of conduct are enforced universally in all cases irrespective of circumstances and/or consequences. The degree of effectiveness of rule enforcement is determined by the degree to which the objective of achieving social justice becomes an integral part of the subjective interiority of the members of the society.

The stronger the compliance by individuals in the society, the more self-sustaining and self-enforcing the rules become. For this outcome to be attained, the rules must be internalized by individuals as endogenous elements of their own minds which find external expression when the rules become shared beliefs among individuals in the society. The stronger are the shared beliefs, the stronger would be the coordinated collective actions and the more stable the society.

The *Qur'an* makes clear that rule compliance is the guarantor of social justice, social cohesion, unity and order in any human collectivity (*Qur'an* 5:2; 3:103; 8:46). This is so central among the objectives of the meta-framework that it can be claimed that all rules of behavior prescribed are those that lead to social justice, integration, cohesion, solidarity and unity. Conversely, all prohibited behavior is that which ultimately leads to social injustice and disintegration. Central among the rules that constitute the institutional structure of the ideal economy are rules governing property; production, exchange, distribution and redistribution; and market conduct, as discussed below.

**Rules of Conduct and the Social Order** The function of rules of conduct is to provide the means by which individuals can overcome the obstacles presented by their ignorance of particular facts that must exist to determine overall justice in the social order. Rules specify what kind of conduct is appropriate in certain circumstances. Rules are specific means to specific ends. They are, essentially, restrictions on what individual members of society may do without upsetting the social order. All individuals count on the social order in deciding on their individual choices and actions. Therefore, rules should guide individuals in their actions. If emotions and impulses tell them what they want, the rules tell them whether or not they can have it and how they will be able and allowed to get it. Additionally and importantly, observance of rules of conduct integrates individuals into society. Rules serve to prevent conflicts, reconcile differences and facilitate cooperation among individuals. Compliance with them promotes social integration and unity and preserves the intended social order.

**Enforcement Mechanism** The enforcement characteristics of Islamic rules are that each and every individual is made responsible for knowing the rules for themselves and then for ensuring that others know them as well. The enforcement mechanism is embodied in the most important of all social duties for Muslims—to ensure that all individuals are both familiar with and comply with the rules of just conduct prescribed by Islam.

If these rules are not generally known or understood because both individuals and their collectivities have avoided their duty, compliance will be lacking or fundamentally weak. In that case, imposition by fiat of an Islamic economic superstructure, whatever that may mean under the circumstances, will not produce the desired result. But once the rules are known and understood, individuals, the government and society at large all have the duty and the responsibility to ensure compliance and enforcement.

More specifically, Islamic economics can be considered as a discipline concerned with: (a) the rules of behavior (institutions) prescribed by Islam as they relate to resource allocation, production, exchange, distribution and redistribution; (b) the economic implications of the operations of these rules and; (c) the incentive structure and policy recommendations for achieving compliance that would allow convergence of the actual economy with the ideal economic system envisioned by Islam.

## **CORE ECONOMIC INSTITUTIONS IN ISLAM**

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With this background, let us examine the rules prescribed by Islam with respect to core values of the society concerning property rights, contractual agreements, trust, and many others. These rules in turn lay the foundation for core economic institutions in Islam and ultimately, the collection of these institutions define the economic system prescribed by Islam. The core economic institutions which ultimately define the economic system prescribed by Islam are as follows.

### **Property Rights**

While the individual's right to property affirms the natural tendency in man to possess—particularly something resulting from his own creative labor—the concomitant private property obligations, from the point of view of justice, are designed to give effect to the interdependence of the members of the community, with a view to recognizing explicitly that they cannot live in isolation. The private property obligations, therefore, reject the notion that a person does no harm to members of his group if as a result of his effort he is better off and others are no worse off than they would otherwise be. These obligations write the principle of sharing into the delineation of interests in property and consider private ownership to be subject to a trust, or a duty, in order to effect sharing. Hence, private initiative, choice, and reward are recognized in Islam's conception of property rights, but such recognition is not allowed to subvert the principle of sharing or to lead to violations of the rights of the community. If, as a result of the growth of society, division of labor, or increasing complexities of markets, either the obligation to share is shirked or the rights of the society and the cohesion of the community are undermined, an intervention by the legitimate authority to take corrective measures would be deemed justified.

The word “property” is defined as a bundle of rights, duties, powers, and liabilities with respect to an asset. In the Western concept, private property is considered the right of an individual to use and dispose of a property, along with the right to exclude others from the use of that property. Even in the evolution of Western economies, this is a rather new conception of property that is thought to have accompanied the emergence of the market economy. Before that, however, while a grant of the property rights in land and other assets was the right to use and enjoy the asset, it did not include the right to dispose of it or exclude others from its use. For example, the right to use the revenues from a parcel of land, a corporate charter, or a monopoly granted by the state did not carry the right of disposing of the property. It is thought that the development of the market economy necessitated a revision of this conception of property since it was thought that the right not to be excluded from the use of assets owned by another individual was not marketable; it was deemed impossible to reconcile this particular right with a market economy. Hence, of the two earlier property rights principles—the right to exclude others and the right not to be excluded by others—the latter was abandoned and the new conception of property rights was narrowed to cover only the right to exclude others. In Islam, however, this right is retained without diminishing the role of the market as a mechanism for resource allocation and impulse transmission within the framework.

The key principles of Islamic property rights are as set out below:

- The first principle is that the Supreme Creator is the ultimate owner of all properties and assets, but in order that humans become materially able to perform duties and obligations prescribed by the Law Giver, they have been granted a conditional right of possession of property. This right is granted to the collectivity of humans.
- The second principle establishes the right of collectivity to the created resources.
- The third principle allows individuals to appropriate the products resulting from the combination of their labor of these resources, without the collectivity losing its original rights either to the resources or to the goods and services by individuals.
- The fourth principle recognizes only two ways in which individuals accrue rights to property: (i) through their own creative labor and/or (ii) through transfers—via exchange, contracts, grants, or inheritance—from others who have gained title to a property or an asset through their labor. Fundamentally, therefore, work is the basis of the acquisition of rights to property. However, work is performed not only for the purpose of satisfaction of wants or needs but is considered a duty and obligation required of everyone.
- The fifth principle, referred to as “the immutability or invariance of ownership”<sup>1</sup> constitutes that the access to and use of natural resources for producing goods and services is also everyone’s right and obligation. So long as individuals are able, they have both the right and the

obligation to apply their creative labor to natural resources to produce goods and services needed in the society. However, if individuals lack the ability, they no longer have an obligation to work and produce without losing their original right to resources.

- The sixth principle imposes the duty of sharing the natural resources. This principle regards private property-ownership rights as a trust held to effect sharing. Before any work is performed in conjunction with natural resources, all members of society have an equal right and opportunity to access these resources. When individuals apply their creative labor to resources, they gain a right of priority in the possession, use or market exchange of the resulting product without nullifying the rights of the needy in the proceeds of the sale of the product.
- The seventh principle imposes a limitation on the right of disposing of the property—presumed to be absolute in the Western conception of property rights. Individuals have a severely mandated obligation not to waste, destroy, squander, or use property for unlawful purposes.

Islam recognizes that the Divine Providence has endowed individuals with unique and unequal abilities and that some individuals have greater mental and/or physical capacities and, consequently, are capable of obtaining title to a larger amount of property and assets. But this only means that such individuals' responsibilities and obligations are greater than those of others. However, once these individuals have discharged their duties of sharing, in the prescribed manner and in the prescribed amount, and provided they are not in violation of the rules of *Shari'ah*, their rights to their possessions are held inviolate and no one has any right to force appropriation (or expropriation) of that person's property to anyone else. This right is held so sacred that even when rules had to be developed for emergency cases of expropriation for projects of public utility it was called "legitimate violation" (*ikrah hukmi*). Even then, such actions could be taken only after adequate compensation was paid to the owner of the property. To violate the legitimate property rights of a person is considered to be "oppression" and "exploitation," just as there is "discord and corruption on earth" when individuals do not discharge their private property obligations.

While the above principles strongly affirm people's natural tendency to possess, the concomitant obligations give rise to the interdependence of members of society. Private initiative, choice, and reward are recognized but not allowed to subvert the obligation of sharing. The inviolability of appropriately acquired private property rights in Islam deserves emphasis. As one legal expert observed, given the divine origin of Islam:

*... its institutions, such as individual ownership, private rights, and contractual obligations, share its sacredness. To the authority of law, as it is understood in the West, is added the great weight of religion. Infringement of the property and rights of another person is not only a trespass against the law; it is also a sin against the*

*religion and its God. Private ownership and individual rights are gifts from God, and creative labor, inheritance, contract, and other lawful means of acquiring property or entitlement to rights are only channels of God's bounty and goodness to man. . . . All Muslim schools teach that private property and rights are inviolable in relations between individuals as well as in relations with the state. . . . It is not only by their divine origin that the Muslim institutions of private ownership and right differ from their counterpart in the Western system of law; their content and range of application are more far-reaching . . . If absolutes can be compared, it can be safely said that the right of ownership in Muslim law is more absolute than it is in the modern system of law. . . . The Muslim concept of property and right is less restricted than is the modern concept of these institutions. (Habachy 1962)*

The *Shari'ah* outlines the obligations concomitant with property rights. Among the obligations is, first, the responsibility of sharing the proceeds or the use of property—and, secondly, the obligation not to waste, destroy, squander, or to use the property for purposes not permitted by the *Shari'ah*. To do so would be to transgress the limits set on one's rights and an encroachment on the rights of the collectivity. This position of the *Shari'ah* is in conformity with the Islamic conception of justice and the rights and responsibilities of the individual and the community.

## Contracts

In any economic system, individuals not only make choices for themselves, but they also interact with other members of the society through transactions facilitated by explicit and implicit contracts entered into within the bounds specified by the institutional setting of the society. A contract is a time-bound instrument with an objective. The contract stipulates the obligations that each party is expected to fulfill in order to achieve the objectives of the contract.

The concept of contracts in Islam is not only important in the legal aspect of exchange, as an institution necessary for the satisfaction of legitimate human needs, but it is also a concept upon which the *Shari'ah* is based. The whole fabric of the Divine Law is contractual in its conception, content and application. The foundation of the *Shari'ah* is the covenant between Allah (*swt*) and man, which imposes on man the duty of being faithful to his word. The *Qur'an* reiterates that "Allah (*swt*) will not fail in His Promise."

Throughout the legal and intellectual history of Islam, a body of rules constituting a general theory of contracts—with explicit emphasis on specific contracts, such as sales, lease, hire, and partnerships—was formulated on the basis of the *Shari'ah*. Contracts are considered binding, and their terms are protected by the *Shari'ah*, no less securely than the institution

of property. This body of rules established the principle that, in matters of civil and economic dealings, any agreement not specifically prohibited by the *Shari'ah* is valid and binding on the parties and can be enforced by the courts, which treat the parties to a contract as complete equals.

Islam forcefully anchors all social-political-economic relations on contracts. More generally, the whole fabric of the Divine Law is contractual in its conceptualization, content and application. Its very foundation is the Primordial Covenant between the Creator and humans—the *Mithaq*—which imposes an obligation to comply with the rules prescribed by their Supreme Creator as its Cherisher Lord (*Rabb*). In Islam, faithfulness to the terms of all contracts entered into is linked to the fulfillment of obligations incurred under the Primordial Covenant.

The rule of remaining faithful to the discharge of contractual obligations derives its power and authority from the generalization of the responsibility of remaining faithful to the Primordial Contract.<sup>2</sup> A believer will only take on contractual obligations intending to fulfill them.<sup>3</sup> Believers are said to protect their contractual obligations as a shepherd protects his sheep.<sup>4</sup>

Muslims are constantly reminded of the importance of contractual agreement, as they are required by their faith to honor their contracts.<sup>5</sup> As directed in the *Qur'an*, Muslims put their contracts in writing in order to reduce the possibility of any misunderstanding or ambiguity concerning the responsibilities of the parties to the contract. *Shari'ah* scholars often point out that one of the reasons why the Islamic system of *muamalat* (transactions) is so highly articulated is that it is based on solid principles of contracts and the rights and obligations of the parties to the contract. The dynamic of contracts and the process of *ijtihad* inherent to *Shari'ah* have ensured that Muslim jurists continue to comment and build upon the theoretical constructs.

The concept of contracts in Islam transcends its usual conception as a legal institution “necessary for the satisfaction of legitimate human need.” The entire fabric of the Divine Law is contractual in its concept and content and, as Habachy (1962) points out, binds humans to their Creator:

*This is not only true of private law contracts, but also of public law contracts and international law treaties. Every public office in Islam, even the Imamate (temporal and spiritual leadership of the society), is regarded as a contract, an agreement (âqd) that defines the rights and obligations of the parties. Every contract entered into by the faithful must include a forthright intention to remain loyal to performing the obligations specified by the terms of contract.*

## Trust

Trust is considered the most important element of social capital in Islam and the cornerstone of the relationship of individuals with Allah (*swt*) and

with others in society. Islam places a strong emphasis on trust and considers being trustworthy as an obligatory personality trait. The root of the word for “trust” (*amanah*) is the same as that for “belief” (*iman*) and the *Qur’an* insists that a strong signal of true belief is faithfulness to contracts and promises. It makes clear that performing contractual obligations or promises is an important and mandatory characteristic of a true believer.<sup>6</sup>

In short, Islam has made trust and trustworthiness obligatory and has rendered them inviolable, except in the event of an explicitly permissible justification.

The life of the Prophet (pbuh) is a shining illustration of the implementation of the guidance of Allah (*swt*) in maintaining trust and remaining trustworthy. Regarded as eminently trustworthy even before his divine appointment (the community conferred upon him the title of *Al-Ameen*—“Trustworthy”), the Prophet expended a great deal of effort in modifying when possible and changing when necessary the behavior of the community in respect of trustworthiness. There are numerous statements, actions, and circumstances attributed to him in which trust was the pre-eminent concern.<sup>7</sup>

In the *Shari’ah*, the concepts of justice, faithfulness, reward and punishment are linked with the fulfillment of obligations incurred under the stipulations of the contract. Justice links man to Allah (*swt*) and to his fellow men. It is this bond that forms the contractual foundation of the *Shari’ah*, which judges the virtue of justice in man not only by his material performance, but also by the essential attribute of his intention (*niyya*) with which he enters into every contract. This intention consists of sincerity, truthfulness, and an insistence on rigorous and loyal fulfillment of what he has consented to do (or not to do). This faithfulness to contractual obligations is so central to Islamic belief that the Prophet (pbuh) defined a believer as “a person in whom the people can trust their person and possessions.” He is also reported to have said that “a person without trustworthiness is a person without religion.” So basic is the notion of contracts in Islam that every public office is regarded, primarily, as a contract and an agreement which defines the rights and obligations of the parties. The highest temporal office, that of *khalifa*, is inaugurated by *mubaya’a*, which is a contract between the ruler and the community that he will be faithful in discharging his duties.

As we have seen, contract and trust are interdependent. Without trust, contracts become difficult to negotiate and conclude, and costly to monitor and enforce. When trust is weak, complex and expensive administrative devices are needed to enforce contracts. Both the *Qur’an* and the tradition of the Messenger stress the importance of trustworthiness as the benchmark that separates belief from disbelief.<sup>8</sup> Trustworthiness and remaining faithful to promises and contracts are absolute, regardless of the costs involved or whether the other party is a friend or a foe.<sup>9</sup> There is also a network of micro-level rules that ensure transparency and the unhindered flow of information. This includes, *inter alia*, the requirement incumbent upon sellers that they must inform the buyers of prices, quantities and qualities; a body of rules governing the consumer’s option to annul a transaction under



various circumstances; the rule of non-interference with market supplies; the rule against hoarding; and the rule against collusion among market participants (Mirakhor 2007).

### **Risk Sharing**

Another core principle of Islamic economics is the notion of risk sharing. This is based on the principle of liability, which states that profit is justified on the basis of taking responsibility, possibly even becoming responsible for the loss and the consequences. This legal maxim, said to be derived from a saying of the Prophet (pbuh) that “profit comes with liability,” implies that *Shari’ah* distinguishes lawful profit from all other forms of gain and that entitlement to profit exists only when there is also the liability, or risk, of loss.

The central proposition of Islamic finance is risk sharing and the prohibition of interest-based transactions in which a rent is collected as a percentage of an amount of the principle loaned for a specific time period without the full transfer of the property rights over the money loaned to the borrower. One result of this type of transaction is that the risk is borne by the borrower. Rather, Islam proposes a mutual exchange (*al-bay’*) in which one bundle of property rights is exchanged for another, thus allowing both parties to share the risks of the transaction—something which is sanctioned. The emphasis on risk sharing is evident from one of the most important verses in the *Qur’an* with respect to economic relations (2:275). The verse states that: “. . . they say that indeed an exchange transaction (*bay’*) is like a *riba* (interest-based) transaction. But Allah has permitted exchange transactions and forbidden interest-based transactions.” The nature of property rights inherent in these two transactions hints at one of their crucial differences. *al-Bay’* is a contract of exchange of one commodity for another where the property rights over one commodity are exchanged for those over the other. In the case of a *riba* transaction, a sum of money is loaned today for a larger sum in the future without the transfer of the property rights over the principle from the lender to the borrower. Not only does the lender retain rights over the sum lent but property rights over the additional sum to be paid as interest is transferred from the borrower to the lender at the time the contract of *riba* is entered into. Arguably, the above verse renders exchange and trade of commodities or/and assets the foundation of economic activity in the Islamic Paradigm.

From this, important implications follow. Exchange requires freedom for parties to contract. This in turn implies freedom to produce, which calls for clear and well-protected property rights to permit production to proceed. To be able to exchange freely and conveniently, the parties need markets. To operate successfully, markets need rules of behavior and enforcement mechanisms to reduce uncertainty in transactions and ensure the free flow of information. They also need trust to be established among participants; competition among sellers, on the one hand, and buyers, on the other; transaction costs to be reduced; and the risk to third parties in having to bear externalized costs of two-party transactions to be mitigated.

## Market Conduct

Rules governing market conduct relate to appropriate behavior on the part of all participants in the market. The *Qur'an* acknowledges the need for markets and affirms their existence, placing emphasis on contracts of exchange (*bayc*) and trade (*tijÉrah*). As a rule, it emphasizes market transactions based on mutual consent; that is, based on freedom of choice and freedom of contract which, in turn, requires acknowledgment and affirmation of private property rights. The archetype model discussed in Chapter 1 operationalized the concept of exchange and trade as well as the use of market as the mechanism for this purpose. A market supervisor is appointed to ensure compliance with the rules of conduct in the market place, which are internalized by participants before their entrance into the market. Compliance with the rules of market behavior ensures prices that are fair and just. So long as market participants comply, no direct interference with the price mechanism is permitted, even though the legitimate authority is responsible for supervising market operations.

The market's institutional structure is built around five pillars: (a) property rights, (b) the free flow of information, (c) trust, (d) contract and (e) the right not to be harmed by others, and the obligation not to harm anyone. Together, they serve to reduce uncertainty and transaction costs and enable cooperation and collective action to proceed unhindered.

**Work and Work Ethics** The concept of work in Islam (*al-amal*) is far broader, and has different characteristics and objectives, than the concept as it is understood in the Western economic tradition. In Islam, the work ethic is defined by the *Qur'an* itself, which stresses the need for work and action by human beings. It is because of this emphasis on work that Islam is considered “the ideology of practice and the practice of ideology” and “a religion of action” (Mirakhor 1988). The *Qur'an* exalts work and raises it to the level of worship, and considers it as an inseparable dimension of faith itself. Conversely, it considers idleness—or the squandering of time in pursuit of unproductive and non-beneficial work—as the manifestation of lack of faith and of unbelief.

Man is called upon to utilize time in pursuit of work by declaring that Allah (*swt*) has made the day as a means of seeking sustenance. A person who through hard work seeks Allah's “bounty”—which includes all appropriate means of earning one's livelihood—is most highly praised. All able-bodied persons are exhorted to work in order to earn their living. No one who is physically and mentally able is allowed to become a liability to his family or to the state through idleness and voluntary unemployment. The work which everyone is required to perform must be “good” or “beneficial” (*al-amal as-salih*), but no work is considered inconsequential in relation to its rewards or punishments in this world and in the next. One will have to reap whatever rewards or retributions are due as a result of his work.

Work, therefore, is regarded not only as a right, but also as a duty and an obligation. Hence, based on its notion of individual rights and responsibilities, Islam extends to the individual the right to choose the type of work they desire, but along with this freedom comes the obligation to consider the needs of the society as well as the selection of the type of work permitted by the *Shari'ah*.

Since all class distinctions are negated by Islam, no line of work permissible by the *Shari'ah* is considered demeaning by Islam, which countenances only diversification on the basis of natural talents, skills and technology—which are considered to be a grace or blessing (*fadl*) from Allah (*swt*) and which all Muslims are urged to acquire—or personal inclinations. Based on its concepts of justice and contracts, Islam makes it an obligation for the worker to perform the tasks which he has contracted to the best of his ability. But since individuals are endowed with different abilities and talents, this productivity will differ. Justice, however, demands that the return for every individual's work must be commensurate with his/her productivity.

While Islam has, in no uncertain terms, decried laziness, idleness, and socially unproductive work, it maintains that those who are physically or mentally unable to work still retain a right to what the society, individually and collectively, produces. This conclusion is based on the principle of invariant claim to ownership, which maintains that all human beings have a right to the resources provided for mankind. Since Allah (*swt*) is also the source of the physical and mental abilities that enable some members of society to possess more than others, the right of ownership to the original resources of those less able remains valid. This follows from the fact that Allah's (*swt*) original right of ownership of resources, which He has created, is not negated when they, along with the creative labor of individuals, are transformed into products, property and wealth.

### **The Accumulation and Utilization of Wealth**

Islam encourages man to utilize, to the fullest extent possible, all the resources that Allah (*swt*) has created and entrusted for his use. The non-utilization of these beneficial resources is tantamount to ingratitude. Wealth is considered an important means by which man can pave the way for the attainment of his ultimate objective. Islam refers to wealth as “good,” an object of delight and pleasure, and a support for the community. Conversely, involuntary poverty is considered to be undesirable and a basis of unbelief. This particular conception of wealth, however, is qualified by the means employed in its earning, possession, and disposal.

Its “earning” is qualified by the emphasis put on the fact that wealth is only a means for the achievement of man's ultimate objective and not an end in itself. It must be earned through “good,” “productive,” and “beneficial” work, as defined in the *Shari'ah*, which also defines the methods of lawfully earning wealth. Not only are lawful methods of earning wealth specified, but the types of economic activity that may lead to unlawfully acquired wealth and are prohibited are also set out. The *Shari'ah* specifies non-permissible

professions, trade and economic activity, which may lead to unlawfully acquired wealth. Even within each profession, the *Shari'ah* specifies proper and improper practices. Just as wealth, rightfully earned and purposefully disposed of, is considered a blessing, wealth acquired or accumulated unlawfully for its own sake is condemned as “corruption” and retrogression to the basest of all negative human qualities—greed.

Islam regards wealth as the lifeblood of the community, which must be constantly in circulation; therefore, its possession excludes the right of hoarding.<sup>10</sup> The implication is that wealth, lawfully earned, must be invested within the community to improve its economic well-being. Investing the wealth is not only measured by the monetary gain associated with it, but also by the benefits that accrue to society, a point that must be borne in mind at all times by the owners of wealth.

The disposal of wealth is also subject to the rules of the *Shari'ah*. First and foremost among these rules is the recognition of the rights of others in this wealth resulting from the principle of invariant claim to ownership. These include levies whose amounts are specified and others whose amounts are left to be determined by the wealth-owner. These levies fall due when wealth exceeds a specific minimum amount (*nisab*). After these obligations are met, the remainder belongs to the owner, but it must be used in accordance with the rules of the *Shari'ah*, which forbids extravagance, opulence, waste, or general abuse of wealth. It cannot be used to harm others or to acquire political power or to corrupt the polity.

While Islam treats wealth, lawfully acquired, possessed, and disposed of, to be sacred and subject to the protection of the *Shari'ah*, it regards the wealth-owner as a trustee who holds his wealth as a trust on behalf of Allah (*swt*) and the community. Hence, his inability to use his wealth properly provides the basis for the forfeiture of his right to that wealth. Extravagance, waste, and general abuse of wealth is the basis upon which the community can consider him a *safih*, a person of weak understanding, and one in possession of “weak intellect” and a person who, along with his own financial and a moral loss, is damaging the interests of the community. There is a principle, *hajr*, according to which such a person's wealth is made the ward of the community, or of its legitimate representatives, who may limit his right to the use to only a part of his property to meet his basic needs.

### The Distribution and Redistribution of Wealth

One of the most important economic institutions that operationalizes the objective of achieving social justice is that of the distribution/redistribution rule of the Islamic economic paradigm. As mentioned earlier, a crucial mission of all messengers and prophets is the establishment of social justice. In practical terms, the *Qur'an* makes clear that this means creating a balanced society that avoids extremes of wealth and poverty, a society in which all understand that wealth is a blessing provided by the Creator for the sole

purpose of providing support for the lives of all. The Islamic view holds that it is not possible to have many rich and wealthy people who continue to focus all their efforts on accumulating wealth without simultaneously creating a mass of economically deprived and destitute. The rich consume opulently while the poor suffer from deprivation because their rights in the wealth of the rich and powerful are not redeemed.

To avoid this, Islam prohibits the accumulation of wealth, and imposes limits on consumption through its rules prohibiting waste (*itlaf*), overspending, and ostentatious and opulent spending (*israf*). It then ordains that the net surplus, after allowing for the moderate spending necessary to maintain a modest living standard, must be returned to members of the community who, for a variety of reasons, are unable to work and hence whose resources that could have been used to produce income and wealth have been utilized by the more able. The *Qur'an* considers the more able as trustee-agents in using these resources on behalf of the less able. In this view, property is not a means of exclusion but inclusion, in which the rights of those less able are redeemed in the income and wealth of the more able. The result would be a balanced economy without extremes of wealth and poverty. The operational mechanism by which the right of the less able is redeemed is the network of mandatory and voluntary payments such as *zakat* (2.5 percent on wealth), *khums* (20 percent of income), and payments referred to as *sadaqat*. Distribution takes place after production and sale, when all factors of production are given what is due to them commensurate with their contribution to production, exchange and sale of goods and services.

Redistribution refers to the post-distribution phase when the charges due to the less able are levied. These expenditures are essentially repatriation and redemption of the rights of others in an individual's income and wealth. Redeeming these rights is a manifestation of belief in the Oneness of the Creator and its corollary, the unity of the creation in general and of mankind in particular. It is the recognition and affirmation that Allah (*swt*) has created the resources for all of mankind, who must have unhindered access to them. The expenditures intended for redeeming these rights are referred to in the *Qur'an* as *ÎadaqÊt*, a derivative of the root meaning "truthfulness and sincerity." Their payments indicate the strength of the sincerity of a person's belief (2:26; 2:272). The *Qur'an* insists that these are rights of the poor in the income and wealth of the rich; they are not charity (17:26; 38:30; 70:25; 19:51; 2:177). Therefore, extreme care must be taken with the recipients' dignity, which may make them self-conscious to the point that they are reluctant to reveal their poverty. The *Qur'an* consequently recommends that payment to the poor be done in secret (2:271–73) and without reproach, ill-treatment or annoyance (2:262–65).

### **Individual Obligations, Rights and Self-interest**

In Islam, human freedom is envisaged as a personal surrender to the Divine Will rather than as an innate personal right. Man is ontologically dependent

on Allah (*swt*) and can only receive what is given to him by the Source of his being. Human rights are a consequence of human obligations and not their antecedent. Man is charged with certain obligations toward his Creator, nature, himself, and other humans, all of which are outlined by the *Shari'ah*. When these obligations are fulfilled, certain rights and freedoms, which are also delineated by the *Shari'ah*, are gained. Limitations that are imposed by the *Shari'ah* on the rights and freedom of the individual are in the direction of removing negative possibilities from human life. The obligations, rights, and limitations defined by the *Shari'ah* must be observed if the individual and the system are to have an Islamic identity.

Within the framework of the *Shari'ah*, individuals have natural rights that are guaranteed, among which is the right of individuals to pursue their economic interests. Islam considers natural rights of the individual as the same rights granted to him by Allah (*swt*). Pursuing one's economic interests, within the framework of the *Shari'ah*, is first an obligation and a duty, then a right that no one can abrogate. What is significant, however, is the fact that if an individual's power and ability to pursue economic interests are lacking, the obligation is no longer incumbent upon the person, while their rights are still preserved. The right to economic benefits is never negated as a result of a lack of ability to undertake their duty to pursue their economic interests. The potential right remains even if a person is unable to actualize it. Conversely, if the person is able but does not perform their obligations, their rights are also negated.

In Islam, and contrary to popular opinion, self-interest is not negated. Islam, in fact, considers it a primary factor in its incentive-motivation system; a necessity in any organized society if the individual is to find it utility maximizing to follow behavioral rules prescribed by the system. Provided that self-interest is defined to cover spiritual and temporal (that is, eternal and temporary) interests, there is not one rule in the *Shari'ah* that does not carry with it its own justification for individual self-interest. It is for his own benefit, material and spiritual, in this world and for his ultimate salvation and felicity in the next, that the individual is invited to follow the rules of the *Shari'ah*. This is made clear by the *Qur'an*, in which all injunctions are generally coupled with the assertion that compliance with them by the individual is for his own benefit. Often the incentives and the rewards for compliance and the retribution for non-compliance, both here and in the hereafter, are enumerated. It is in the context of the pursuit of self-interest that individual obligations and rights, as well as the limits and accountabilities to these rights, are specified by the *Shari'ah*.

### Competition and Cooperation

In the Islamic conception of mankind's ultimate end, economic life plays a purely instrumental role. Even in this role, economic affairs are meant only to provide the institutions and mechanisms needed for satisfying man's

economic needs, as man's essence as the supreme creature of Allah (*swt*) is allowed to be manifested in this world. Thus, the economic system designed in accordance with the fundamental principles of Islam assures that man can exercise his eminent dignity, freedom, responsibilities and rights in the conduct of economic affairs. The economic system must be so ordered as not to assign to man a purely instrumental role in achieving the goals of the economy or the state. Islam seeks to guide man to direct individual action and responsible participation in economic affairs in a manner that commits him to community solidarity and cooperation, resulting in a dynamic and growing economy. Thus, the individual is made accountable for the moral effects of his social actions, including those in economic affairs, so that his own inner personal-spiritual transformation and growth is bound to the progress of the community.

Hence, Islam utilizes cooperation and competition in structuring the ideal society through harmonization and reconciliation between these two opposites, but also between equally primeval and useful forces at every level of social organization. From this perspective, one can argue that one of the greatest distinguishing characteristics of Islam is its forceful emphasis on the integration of human society as a necessary consequence of the unity of Allah (*swt*). To this end, the personality of the Prophet (pbuh) is inseparable from what the *Qur'an* considers as the optimal approach necessary for the emergence of solidarity in human society. Every dimension of the personality of the Prophet (pbuh), manifested in his various social roles in the community, is directed toward maximum integration and harmony in the society. Moreover, every rule of behavior, including those in the economic area, is designed to aid the process of integration. Conversely, all prohibited practices are those which, one way or another, lead to social disintegration.

The *Qur'an* and the traditions of the Prophet (pbuh) make clear references to the dual nature of competition and cooperation; that is, human beings can cooperate and compete for good or evil. It is this that leads to the integration or disintegration of society. The fundamental sources, however, emphasize that competition and cooperation must be utilized in probity and piety rather than in evil and enmity.<sup>11</sup> Similarly, Muslims are urged to compete with one another in beneficial and righteous deeds. There is no evidence in these sources that would allow suppression of one of these forces in favor of the other when they are used within the *Shari'ah* framework. Rather, all of the regulatory and supervisory authority invested in the legitimate political authority is directed toward a balanced and constructive utilization of these forces. The *Shari'ah* rules regarding the structure of the market and the behavior of market participants are an example of such balance. Although the rules of the *Shari'ah* regarding economic affairs demarcate limits and boundaries of desirable competitive and cooperative behavior necessary for the provision and preservation of the solidarity of society, the individual always remains the identifiable agent through whose action (and on whose behalf) all economic activities take place.

## Governance

In addition to the above, there are other individual and collective behavioral rules and norms that strengthen the governance structure of the state and firms, including transparency, accountability, voice, and representation. Nevertheless, the three basic institutions—property rights, contracts, and trust—give a flavor of the strength of governance in Islam. The rule of Law governs the behavior of state rulers no less stringently than those of individuals. As Anderson and Coulson (1958) observe: “Islam is the direct rule of God. His Law, the *Shari’ah*, is the sole criterion of behavior,” and “the authority of the temporal ruler is both derived and defined by this law.” Under the rule of Law, “the ruler is by no means a free agent in the determination of the public interest,” and the decisions that the ruler makes “must not be arbitrary, but rather the result of conscientious reasoning on the basis of the general principles of the *Shari’ah* as enunciated in the authoritative texts.” These legal experts also assert that, based on their consideration of Islamic legal texts, the command of observing contracts and covenants faithfully “apply to the ruler acting in a public capacity” just as severely as to individuals. “Indeed, when considerations of expediency and public interests are taken into account, they apply even with greater force to the actions of the ruler.” Therefore, a breach of faith on the part of a ruler is more heinous in its nature and serious in its consequence than that of individuals. Importantly, they observe:

*. . . just as the ruler has no special prerogative or exemptions as regards the substantive law, so he has none regarding the application of the law through the courts. Ideally, the jurisdiction of the Qādi (the judge), the only person qualified to apply the Shari’ah, is comprehensive and exclusive. The principle that no one can be judge in his own cause is firmly established in the legal texts, and when personally involved, the ruler should submit to the jurisdiction of the ordinary Qādi’s courts. . . . [T]he ruler that breaks faith cannot shelter behind any claim of sovereignty from the dictates of the law which brooks no such plea.*

The same principles of governance under which a ruler or a state should function apply also to firms. Iqbal and Mirakhor (2005) argue that within the Islamic framework a firm can be viewed as a “nexus of contracts” whose objective is to minimize transaction costs and maximize profits and returns to investors subject to constraints that these objectives do not violate the property rights of any party, whether it interacts with the firm directly or indirectly. In pursuit of these goals, the firm honors all implicit or explicit contractual obligations. As can be discerned from the discussions on contracts and trust, it is incumbent on individuals to preserve the sanctity of implicit contractual obligations no less than those of explicit contracts. By the same token, firms have to preserve the sanctity of implicit and explicit



contractual obligations by recognizing and protecting the property rights of stakeholders, community, society, and state. Since the firm's behavior is shaped by that of its managers, it becomes their fiduciary duty to manage the firm as a trust for all stakeholders in ensuring that the behavior of the firm conforms to the rules and norms specified by the Law (Iqbal and Mirakhor 2004).

## **ECONOMIC JUSTICE IN ISLAM**

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A just economy is part of a just, healthy, and moral society, which is the central objective of Islam. What underpins all the rules of behavior prescribed by Islam is its conception of justice, which maintains that all behavior, irrespective of its content and context, must, in its conception and commission, be based on just standards as defined by the *Shari'ah*. Islam considers an economy, in which the behavior of its agents is so conceived, as an enterprising, purposeful, prosperous, and sharing economy in which all members of society receive their just rewards. Such an economy is envisioned as one in which economic disparities that lead to social segmentation and divisiveness are conspicuously absent. Another important rule is the prohibition against taking (that is, receiving) interest. This issue will be covered in detail later.

The components of economic justice in an Islamic society are (i) equality of liberty and opportunity for all members of society with respect to the utilization of natural resources; (ii) justice in exchange, and (iii) distributive justice—all accomplished within the framework of the *Shari'ah*. In this conception, liberty means that a person is not prevented by others from combining his creative labor with resources which are designated by the *Shari'ah* for the use of the individual members of society. Opportunity, on the other hand, represents a favorable conjunction of circumstances, which gives the individual the chance to try it and success is dependent on the individual's efforts and abilities. This equality of opportunity must be secured deliberately by the collectivity. It not only denotes free and equal access to physical resources, but, generally, also extends to technology, education, and environmental resources. The basis for this equality of access to resources and equality of opportunity to use them is Islam's position that natural resources are provided for all members of the society. Even if the opportunity to use these resources is not available to some, either naturally or due to some other circumstances, their original claims to resources remain intact and are not nullified. They must be remunerated for these claims, at some point in time, by the other members who happen to have "or get" greater opportunity to use them.

The idea is that, by mixing their creative labor with resources, individuals create a claim of equity to the possession of the assets thus produced, by virtue of which they can participate in exchange. To allow exchange to take place on the basis of just standards, Islam places a great deal of emphasis on the market and its moral, just and—based on these two factors—efficient

operation. To assure justice in exchange, the *Shari'ah* has provided a network of ethical and moral rules of behavior, which cover in minute detail the behavior of all participants in the market. It requires that these norms and rules be internalized and adhered to by all participants before they enter the market. A market that operates on the basis of these rules, which are intended to remove all factors inimical to justice in exchange, yields prices for factors and products that are considered "fair" and "just." Unlike the scholastic notion of "just price," which lacks an operational definition, the Islamic concept refers to the price prevailing as a result of the interaction of economic forces operating in a market in which all rules of behavior specified by the *Shari'ah* are observed and adhered to by all participants. It is an *ex post* concept, meaning that a just price has been paid and received.

The rules governing exchange in the market cover *Shari'ah*-compatible sources of supply and demand for factors and products before they enter the market, *Shari'ah*-based behavior on the part of the buyers and sellers, and a price-bargaining process free of factors prohibited by the *Shari'ah*. Hence, market imperfection refers to the existence of any factor considered non-permissible by the *Shari'ah*. The rules regarding supply and demand not only govern the permissibility of products demanded and supplied, but also look beyond these phenomena to their origin. Not all demands for products are considered legitimate, nor are all acts of supplying products permissible. The means by which the purchasing power that gives effect to demand is obtained, and the manner in which the production of commodities for their supply takes place, must have their origins based on just standards. Rules governing the behavior of participants in the market are designed to ensure a just exchange. The freedom of contracts and the obligation to fulfill them; the consent of the parties to a transaction; non-interference with supplies before their entry into the market; full access to the market to all buyers and sellers; honesty in transactions; the provision of full information regarding the quantity, quality and prices of the factors and products to buyers and sellers before the start of negotiation and bargaining; and the provision of full weights and measures are all prescribed. On the other hand, behaviors such as fraud, cheating, monopoly practices, coalitions, and combination of all types among buyers and sellers, underselling products, dumping actions, speculative hoarding, and bidding-up of prices without the intention to purchase are all forbidden. All in all, any form of behavior leading to the creation of instantaneous property rights without a commensurate equity created by work is forbidden. A market in which all these conditions are fulfilled produces fair and just prices for the factors and products. These are just or equitable not on any independent criterion of justice, but because they are the result of bargaining between or among equal, informed, free, and responsible men.

Islam's emphasis on moral and just conduct in the marketplace is remarkable in its vigor. A producer or a businessman whose behavior complies with Islamic rules is said to be like the prophets, martyrs, and the truthful friends of Allah (*swt*). He is ranked with the prophets because he, like the prophets, follows the path of justice; like martyrs because they both fight against

heavy odds in the path of honesty and virtue; and like the truthful because both are steadfast in their resolves. Islam asks participants to go beyond the rules of the *Shari'ah* and extend beneficence to one another as a safeguard against injustice. Beneficence implies helping others in ways not required by justice. It is thus different from justice, which prescribes just limits to selfishness. While justice regulates and limits selfishness, beneficence rises above it. Moreover, participants in the market are not only responsible for their own just behavior, but because of the obligation of “enjoining the good and forbidding the evil” they are also made responsible for the behavior of their fellow participants. Islam maintains that when a man sees another committing an injustice toward a third and fails to attempt to remove that injustice, he becomes a party to that injustice. If the person failing to help is himself a beneficiary of this injustice, then his failure is considered tantamount to supporting it. Although provisions are made for coercive and corrective action by legitimate authorities, the clear preference is for self-management of the market. Any interference in the operations of such a market—through price controls, for example—is considered unjust, a transgression and a sin.

It was in response to the rules of market behavior imposed by the *Shari'ah* that led the Muslims early in their history to structure their markets in the form of bazaars, which looked almost the same all over the Muslim world and possessed characteristics that promoted compliance with the rules. Physically, bazaars were structured to guarantee maximum compliance with these rules. Each physical segment of the market was specialized with respect to specific products and the prices showed little variation from one part of the market to the next. The institution of guilds made self-regulation of each profession and trade possible. Additionally, markets were inspected for compliance by a market supervisor (*muhtasib*) who was appointed by local judges. Unfortunately, the institution of bazaars did not have the opportunity to evolve to meet the requirements of an expanding economy or the growing complexity in economic relations. The bazaars that still exist in many parts of the Muslim world, while maintaining their underdeveloped physical and infrastructural nature—most are centuries old and have not been expanded—lack many of the Islamic characteristics and requirements in their operations.

The last component of Islamic economic justice, distributive justice, is the mechanism by which equal liberty and equity are reconciled without the least possible infringement of either. Insofar as the distribution of resources—the just and equal access to these resources, as well as equal opportunity in their use—is guaranteed, the claim to equity on the basis of reward and effort is just. The moral basis of property is the primacy given to equity and it is derived directly from human efforts and achievements. The bases of private property in Islam are: (i) property which is derived from personal ability and effort, including material property made or obtained from natural resources by combining them with personal skills, ability, and technology, income from self-made capital, assets acquired in exchange for the product of the owner's labor; (ii) property acquired by transfers from the

producer; and (iii) property acquired through inheritance from the producer. Rules regarding distributive justice operate through the second and third of these bases.

Assuming equal liberty and opportunity, whenever work has to be performed for the production of wealth, the output of different people may vary greatly both in quality and quantity. Equity then demands that, commensurate with their productivity, different people receive different rewards. Hence, starting from the equality of liberty and opportunity of access to resources, equity may lead to inequality. Moreover, the allocation of resources arising from the operation of the market will reflect the initial distribution of wealth as well as the structure of the market. Assuming that both the operation and the structure of the market are just, there is no logical reason to assume that the market outcome, by and of itself, will lead to equal wealth distribution. Consequently, the result may be (and often is) that inequalities, equitably created, will have immediate and longer-term implications. It is here that the distributive mechanisms of Islamic economic justice attempt to modify inequalities equitably created.

As we saw earlier, Islam recognizes claims based on equality of liberty and opportunity, which are reflected in the degree of access to resources, the degree and extent of the ability of persons to actualize their potential liberty and opportunity, and the right of prior ownership. The right that the less able have in the wealth of those who have greater ability and opportunity to produce greater wealth is redeemed through the various levies (*zakat*, *khums*, *sadaqa*, *nafaqa*, and so on), the payment of which is not beneficence but a contractual obligation that must be met. Islam also encourages beneficence over and above these obligatory dues, but these levies are in the nature of returning to others what rightfully belongs to them. Shirking from this obligation causes a misdistribution of wealth, which Islam considers as the major source of poverty.

Islam asserts unambiguously that poverty is neither caused by scarcity or paucity of natural resources, nor by a lack of proper synchronization between the modes of production and distribution. Rather, it is a result of waste, opulence, extravagance, and non-payment of what rightfully belongs to less able segments of the society. This position is illustrated by the Prophetic saying that: "Nothing makes a poor man starve except that with which a rich person avails a luxury." This is why waste, abuse of wealth, extravagance, and excessive consumption are condemned as unjust, particularly when they occur in conjunction with poverty that they can help to alleviate. In the morality of property, Islam unequivocally considers all individuals entitled to a certain standard of life; and it is this entitlement that entails the satisfaction of their claim as a matter of equity and justice.

In Islam, the rules of inheritance modify the distribution of wealth to the next generation based on the principle that the right of the owner to his wealth ceases upon his death. The power of the person to bequeath his wealth as he wishes is recognized, but is basically restricted to a maximum of one-third of his net assets.

The *Qur'an* (4:11–12) clearly specifies the exact manner in which the shares of heirs are to be determined in the inheritance. Among the same category of heirs there is neither preferential treatment nor discrimination, though a woman's share is generally one-half of a man's share because, under the rules of the *Shari'ah*, responsibility for the maintenance of the family rests upon the husband. Even if the wife has a larger income and greater wealth (from her own work or from inheritance), she is not required to share that wealth or income with her husband and is under no legal obligation to make any contribution toward her family. Considering the nature of the (extended) family ties and mutual responsibilities exhorted by Islam, its institution of inheritance breaks up the wealth of each generation and redistributes it to the next in such a way that a large number should receive a modest portion of such wealth, rather than it going to a single heir or a small number of heirs.

### **Role of the State**

Since Islam considers economic relations and behavior as the means of social and spiritual integration, economic attainments are not to be viewed as ends in themselves. All the rules of behavior regarding economic matters are addressed to individuals and their collectivity, which is represented by the state. The state is regarded as being indispensable for the orderly organization of social life, the achievement of legitimate objectives, the creation of material and spiritual prosperity, and the defense and propagation of faith. The state is primarily a vehicle for implementing the *Shari'ah* and derives its legitimacy from its enforcement of the *Shari'ah* rules. It is assumed to be empowered to use, within the limits of the Law, all available means at its disposal to achieve the objectives and duties prescribed for the collectivity, including the synchronization of individual and public interests.

Foremost among the collective duties is that to ensure that justice prevails in all walks of social life. Thus, the establishment of a judiciary or judicial system, with all the apparatus necessary for carrying out the verdicts of the courts, free of any charges and available to all, is regarded as an indispensable duty of the state. Another of its duties is to guarantee equal liberty and opportunity in access to and use of resources identified by the *Shari'ah* for the use of individuals. This covers making the provision of education, skills and technology available to all. When both equal liberty and equal opportunity are provided, then the production of wealth, its possession and exchange become matters of equity. All of the infrastructure necessary for markets to exist and operate has also been traditionally the responsibility of the state. The first market for the Muslim community was built in Medina at the direction of the Prophet (pbuh) who required that trade be allowed to take place in that market freely, without any charges or fees imposed on the participants and appointed supervisors for the market. On this basis, jurists have recognized market supervision, and its control only when necessary, as a duty of the state.

As we have seen, Islam recognizes as inviolable the right of those unable to actualize their potential to have equal liberties and opportunities in the wealth of those more able. Thus Islam, as praxis for the believer, requires a balance between libertarian and egalitarian values. Where payment of the obligatory levies mandated under *Shari'ah* rules is shirked, the state has a responsibility to correct the resulting misdistribution.

The eradication of poverty is undoubtedly one of the most important of all duties made incumbent upon the state, second only to the preservation and propagation of faith, whose very existence is considered to be threatened by poverty. Islam regards poverty primarily as a failure on the part of the more able and wealthy members of society to perform their prescribed duties. Hence, the commitment to distributive justice, which normally constitutes a large portion of governments' budgets in other systems, is placed squarely on the shoulders of the individuals with the financial and economic capability to meet it. Not only does the *Shari'ah* specify who must pay, but it also designates explicit categories of recipients.

To summarize, the role of the state in an Islamic economy relates, firstly, to ensuring that everyone has equal access to natural resources and means of livelihood; secondly, to ensuring that each individual has equal opportunity—including education, skills, and technology—to utilize these resources; thirdly, to ensuring that markets are supervised in such a manner that justice in exchange can be attained; fourthly, to ensuring that transfer takes place from those more able to those less able in accordance with the rules of the *Shari'ah*; and, finally, to ensuring that distributive justice is done to the next generation through the implementation of the laws of inheritance. The state is then empowered to design any specific economic policy that is required in order to guarantee the attainment of these objectives. To meet the necessary expenditures associated with the performance of its duties, the *Shari'ah* has given the control, utilization, and management of a portion of a society's natural resource endowment (mineral resources, for example) to the state. The consensus of opinion among jurists is that the state is also empowered to impose taxes whenever there is a gap between the resources it can command and its expenditures. Borrowing by the state, when it does not involve paying interest, is permitted when and if necessary.

## **SIGNIFICANCE OF BARAKAH**

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An important aspect of the analysis of an economic system relates to the incentive-motivation structure which the system embodies. The purpose in considering this aspect is to determine whether or not an individual within the system will find it utility maximizing to follow the behavior rules prescribed by the system. If the answer is in the affirmative, then the system as a whole will operate according to its rules. If the rules are not incentive-compatible, there will be deviations from those rules.

The incentive-motivation aspects of the Islamic system have their origin in the basis of belief in Islam, which considers adherence to its rules of behavior as primarily serving the best interests of the individual, both in this world and the next, as well as those of the society as a whole. Islam has provided these rules without negating either the drives or the self-interests of the individual. At the same time, its Law has provided methods and procedures whereby the interests of the community can be protected, should the individual feel it utility maximizing to violate the rules and thereby damage the community's interests.

An important factor in the incentive system of Islam is the concept of *barakah*, which serves as the material inducement for the individual to follow the path of proper conduct. This notion refers to an “invisible but material” blessing whose results can be observed by any believer who engages in righteous conduct. It encompasses the whole spectrum of man's conduct, including, most importantly, his economic behavior. The concept maintains that righteous conduct—that is, behavior whose motivation and objective is to please Allah (*swt*)—will have returns with an increasing rate. The more righteous the conduct, the greater is the presence of *barakah*. This concept asserts that expending wealth in this cause (without expecting a return from the receiver directly) will lead to its expansion. Such actions will, in fact, bring manifold returns to the giver. The concept establishes a positive correlation between the system's conduct and prosperity and encourages Muslims to go beyond the minimum requirements of the *Shari'ah*. The converse of the concept also holds true. That is, unrighteous conduct in earning, possessing, or disposing of wealth will rob its holder of its *barakah*. This applies not only to individual behavior, but to the community as a whole and because the results of the operation of *barakah* are observable, it serves as an incentive for compliance with rules.

## THE MODEL OF MAN

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The Islamic economic paradigm is a Creator-centered conceptualization of reality. Its view of man distinguishes between the exterior, physical form (*bashar*) and the non-physical, substantive and internal substance full of potentialities (*insan*). The two concepts roughly parallel man and human. In exteriority, they are similar in appearance, but there are significant differences between the two. The most important difference between the two is an active awareness of the supreme Creator and Cherisher Lord of the Worlds which separates a “*bashar*” from an “*insan*.” Those of mankind who become aware and conscious of their human state and its potentialities focus on continuous actualization of this potential. The passage from *bashar* (man) to the perfect human state is seen as an upward spiral movement marked by the degrees of compliance with the prescribed rules of behavior.

In the ideology of Islam, man possesses a dual dimension: his body connects him to the material world but he also possesses a cosmic dimension

through his soul, which is in ceaseless journey towards the final meeting with Allah (*swt*).

The sole declared purpose of man is to “serve” Allah (*swt*) and to do so in accordance with His commands. This service (*ibada*) is the implementation of the divine imperative for man and is for his own benefit. The notion of service indicates the act of the removal of barriers (material and otherwise) which exist along the path to that final meeting.

Man’s designated role as Allah’s vicegerent on earth, bestows particular responsibilities which are composed of developing his own potentialities and struggling for the creation of a just and moral social order. Man is provided with material and extra-material means to assist him in discharging his duties. Through his intelligence and will, he can discern and then choose between right and wrong, between just and unjust, between true and false, and between the real and the illusory. Although this power of discernment has been imprinted on his soul, he is provided with guidance in the form of the *Qur’an* and with reminders in the persons of the prophets and others to show him the “right path.” These are there to remind him that there will come a day of reckoning, “the Hour,” when deeds and misdeeds will be judged. Through these means, he is constantly reminded of the transitory nature of this world and the permanence of the next, of what he must do to earn happiness in this life and felicity in the next, of his purpose, and of his responsibilities. Finally, all created phenomena in the material world have been subjected to man’s use in order to provide him with the necessary material means to perform his responsibilities. Through his intelligence man is charged with the power to discover the knowledge which is necessary to utilize the natural resources to the fullest possible extent in enabling him, and his kind, to actualize their full potential.

Thus, Allah (*swt*) creates, preserves, guides, and finally judges man vis-à-vis the performance of his responsibilities. Hence, man’s purpose is defined, his responsibilities are designated, necessary means of discharging these responsibilities are provided, guidance and reminders are constantly made available and the promise and criteria of the final judgment, as well as the rewards and retributions commensurate with obedience and transgression, are made known; it is, then, man’s free will and choice which determine which path he, in fact, chooses.

Islam, then, models man as a being whose behavior, including in its economic dimension, is teleological in nature. Whatever he thinks or does is accomplished with his final purpose in mind. His behavior is oriented toward his final destination. Things of this world, including material possessions, represent only the means by which he can come closer to his final goal. In his thought and behavior he is constantly aware of the presence of Allah (*swt*), who is “closer to him than his jugular vein.”<sup>7</sup> This awareness extends not only to the individual’s own affairs, but, particularly, also to his day-to-day dealings with others. This ever-present consciousness (*taqwa*) is a crucial concept in the *Qur’an* and represents an “awe,” a “fear,” or a “heeding,” which a believer feels when fully conscious of Allah’s (*swt*) presence in



his daily life and in his dealings with others. It represents a defense mechanism, an “inner torch” by which man can distinguish between right and wrong, seeming and real, ephemeral and lasting. It is by this mechanism that he can defend himself against the temptations of the lower instincts. The becoming process and the evolutionary process toward perfection take place through the constant strengthening of this inner torch.

## SOCIETY

The central aim of Islam is to establish a just, moral, and viable social order through the agency of man. Hence, the individual and the society are viewed as correlates. The position of vicegerent and its concomitant responsibilities are conferred upon all of mankind. Humanity has a collective responsibility to ensure that every human being has the opportunity to tap their dormant potential and to remove all obstacles from the individual's path to the ultimate goal. It is this collective view that evokes the matter of the Unity of mankind, which leads to the equality (that is, before the Law) of its members. Islam enunciates the principle that all mankind has been endowed with the same nature. It assumes, affirms, and confirms the equality of the entire human race and obliterates all basis of distinction except goodness, virtue, and service to Allah (*swt*). The principle of the Unity of mankind is derived from the central doctrine of Unity and Oneness of Allah (*swt*) around which every aspect of Islam revolves. This principle leads to the conclusion that Islamic society is an open-ended community that encompasses humanity as a whole.

The Islamic community was brought into existence as a “community of the middle,” “justly balanced,” a “witness” to all nations, whose chief characteristic is the belief in the certainty of the Absolute and His Oneness.<sup>8</sup> The central function of this community is to “command the good and forbid the evil;” and whose members possess the moral consciousness to fully realize their obligations to their fellow men and to society.

Islam regards communities as having rights and responsibilities distinct from those of the aggregation of their individual members and, like individuals, are accountable for their actions. The *Qur'an* asks Muslims to consider the fate of communities and civilizations that went before them and see how they, through the operations of immutable laws that govern the rise and fall of peoples, received what they deserved and take lessons from it.<sup>10</sup>

The Islamic community, as well as each of its members, is charged with the responsibility of preserving, promoting, and propagating Islamic values and laws if it is to flourish and accomplish its missions and objectives. Islam considers the existence of an Islamic community indispensable for the achievement of the Divine purpose and recognizes that all individuals exist in a cultural and sociological environment and owe much of their perception of the world, and many of their reactions to its phenomena, to this environment and other individuals who share it. Much of the significance of this community relates to the need for acquisition, acculturation, and inculcation of the

basic Islamic values, which, *ipso facto*, represent the growth of a Muslim personality. The well-knit way of life in the Islamic community molds individual behavior in its own design. Islamic principles, which deal with the formation, preservation, and continuation of the Islamic community, reflect the dialectic interaction of psycho-physiological requirements of individuals, on the one hand, and the necessary socioeconomic order envisioned by Islam, on the other. This interaction is absolutely crucial to the development of behavior, including its economic dimension, of the individual and the collectivity envisioned by Islam.

Inasmuch as Islam's greatest emphasis is on the development of the individual's active moral consciousness in all his/her social interactions, the existence of political authority in society does not absolve the individual of the performance of duties with which he/she is charged. Adherence to moral principles and the doctrinal antecedence logically predispose a Muslim to an active and assertive political role in society. It is the active moral consciousness of the individual and the duty of "commending the good" and "forbidding of evil" which give the individual Muslim the right and the obligation to participate in the affairs of the community.

## THE POLITY

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Islam considers justice as the foundation of the polity. The Unity of Religion and the Law, which exists in principle, must be carried out in practice. Without an organized political authority the existence of both Religion and the Law may be endangered; without the constraints of the *Shari'ah*, the polity will degenerate into an unjust and tyrannical political order. Only in pursuit of justice can the polity be expected to fulfill the ends for which it was established. The pursuit of justice results in a convergence between the interests of the ruler and the ruled, leads to the improvement of social and economic conditions, and enhances the power of Islam in society. Two factors are necessary for this: the moral consciousness of the individual in not transgressing the limits set on their behavior by the *Shari'ah* and the faithfulness of the political authority to the terms of its contract in ensuring that the rules of the *Shari'ah* are implemented.

## ENDNOTES

1. This concept was originally articulated by As-Sahid As-Sadr (M.B.) in *Iqtisaduna* (1987). Along with the first two principles of property, this provides the justification for the dictum that in the property of the rich there is a right for the poor and serves as the basis for legislation empowering transfer of income and wealth as well as rules against waste and extravagance in consumption.
2. In a direct, clear, and unambiguous verse (6:152), the *Qur'an* commands: "... fulfill the Covenant of Allah." In an equally clear verse (5:1), it generalizes this imperative to all contracts: "... fulfill all contracts."

3. See 16: 91-92; 17:34.
4. See 23:8.
5. See, for example, 5:1; 2:282; 6:151 153; 9:4; 16:91-4; 17:34-6; 23:8.
6. See, for example, 2: 58 and 283; 12: 52; 23: 1-8; and 42: 107, 125, 143, 162, 178, 193.
7. For example, in a few short, but significant statements (quotations from Payandeh 1984), he declares:
  - “The person who is not trustworthy has no faith, and the person who breaks his promises has no religion.”
  - “Maintaining promises perfectly is a sign of faith.”
  - “There are three (injunctions) that no one is allowed to violate: treating parents kindly regardless of being Muslim or non-believer; keeping a promise whether to a Muslim or to a non-believer; and returning what is entrusted for safekeeping—regardless of whether the person entrusting is a Muslim or a non-believer.”
  - “Return what is placed in your trust for safekeeping to the person who has trusted you and do not betray even the one who has betrayed you.”
  - “Three (behavioral traits), if found in a person, then he is a hypocrite even if he fasts, prays, performs bigger and smaller pilgrimages, and says ‘I am a Muslim:’ when he talks, he lies; when he promises, he breaches; and, when trusted, he betrays.”
8. See 2:282; 4:105, 107-08; 6:152; 8:127 and 75-6.
9. See 9:4.
10. *Qur'an* 9:34.
11. See the *Qur'an* 5:2.

## CHAPTER 3

# ***Riba* vs. Rate of Return**

**A**s set out earlier, the Islamic economic system is a rules-based system founded on the preservation of property rights and the sanctity of contracts. Beginning from the notion of property as a sacred trust, the *Shari'ah* ensures its protection from any exploitation through unjust and unfair dealings. The prohibition of *riba* (interest), the elimination of contractual ambiguity (*gharar*) and other forms of exploitation are some of the implications of these core principles.

The significance of contracts and the related obligations cannot be overstated. In this context, financial transactions are no different from any other set of contracts that are subject to compliance with *Shari'ah* principles. Primarily, a financial transaction is considered valid if it fulfills the basic requirements of a valid legal contract and does not contain certain elements such as *riba* (interest), *gharar* (lack of information disclosure), *qimar* (gambling) and *mysir* (games of chance involving deception). While the prohibition of *riba* is the most critical and gets the most attention, the importance of *gharar* and other elements should not be underestimated. Historically, jurists or *Shari'ah* scholars did not cause unnecessary interference in economic activities and gave various economic agents full freedom to contract, providing that certain basic requirements, such as the prohibition of *riba*, were met.

The prohibition of *riba* is not confined to Islam alone, but has a long history spanning several traditions and civilizations (see Appendix A). The prohibition does not arise from any formal economic theory as such, but stems from a Divine order in the *Qur'an*. However, *riba* was not precisely defined at the time of the revelation, an omission often attributed to the fact that since the concept was not in vogue at the time there was no need to provide a formal definition. Defining the term in modern times in any language other than Arabic adds further complexity. For example, unfortunately, there is no single word in contemporary English that serves as an equivalent and accurate translation of the term.

For our purposes, a simple definition of *riba* could be “the practice of charging financial interest or a premium in excess of the principal amount of a loan.”

## THE CONCEPT OF *RIBA* IN ISLAM

Literally, the Arabic term *riba* refers to excess, addition and surplus, while the associated verb implies “to increase, to multiply, to exceed, to exact more than was due, or to practice usury.”<sup>1</sup>

Early Muslim scholars considered money to be a medium of exchange, a standard of value and a unit of account, but rejected its function as a store of value. Lending on interest was prohibited because this was an act of ingratitude and considered to be unjust, since money was not created to be sought for its own sake, but for other objectives. The *Qur'an* (2: 275) makes a clear distinction between engaging in trade and commerce, and earnings through *riba*: “However, God permits commerce, and prohibits usury (interest).” The concept of *riba* was clear in the minds of early jurists, scholars and practitioners. For a long time, and before the introduction of paper currency, the majority of *Shari'ah* scholars always considered the question of *riba* in the context of an exchange contract (*sarf*)—that is, as a sale or exchange of currency or money—or as a sub-heading under trade. Only a few scholars discussed the subject under the heading of loan (*qard*).

*Riba* was interpreted variously by classical scholars as increase which has no wealth (*mal*) corresponding to it; or as reward for waiting; or that which accrues to the lender on account of a deferred payment from an extension in the actual period of loan. At the time of the prohibition, it was a common practice for people to lend money on the condition that a specific amount would be payable periodically as interest and that the principal amount would remain to be paid. At the expiry of the loan, if for any reason the borrower was unable to meet the obligation, the lender would offer to extend the lending period subject to an increased rate of interest. The concept of *riba* is not confined to money-lending, however, but extends to include the exchange of goods as well. *Shari'ah* recognizes two forms of *riba*, as follows:

- ***Riba al-nasiah*** deals with *riba* in money-to-money exchanges, where the exchange is delayed or deferred and gives rise to an additional charge, as practiced in today's financial transactions. The prohibition under the *Shari'ah* applies regardless of whether the return is a fixed or variable percentage of the principal, or an absolute amount to be paid in advance or on maturity, or a gift or service to be received as a condition for the loan.
- ***Riba al-fadl*** is more subtle and deals with hand-to-hand or barter exchange. The prohibition is derived from the sayings of the Prophet (pbuh), who required that commodities be exchanged for cash rather than through barter since there may be differences in the quality of goods, which may give rise to an unjust increase. The concept of *riba al-fadl* is remarkably similar to the prohibition of increase in lending victuals in the

Old Testament (Leviticus 25:37). Whereas the Old Testament prohibits quantitative increases, *riba al-fadl* prohibits qualitative increases as well. Considering that in today's markets exchange takes place through the medium of money, the relevance of *riba al-fadl* has diminished, but the essence of the concept remains applicable to similar situations.

## DEFINITION OF *RIBA*

Focusing on *riba* in financial transactions, it is now possible to construct a more formal definition of the term. According to the *Shari'ah*, *riba* technically refers to the "premium" that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in the duration of loan. At least four characteristics define the prohibited interest rate: (1) it is positive and fixed *ex ante*; (2) it is tied to the time period and the amount of the loan; (3) its payment is guaranteed regardless of the outcome or the purposes for which the principal was borrowed; and (4) the state apparatus sanctions and enforces its collection.

This definition is generally accepted by all and is clear, straightforward, and unambiguous. However, it is the interpretation and scope of the prohibition and its applicability to practical life which raise several questions for *Shari'ah* scholars as new situations arise. The four most commonly asked questions relate to whether the prohibition is limited to consumer loans only, whether only excessive interest or compounding of interest is prohibited, whether adjustment for inflation or any indexation in any form falls within the definition, and whether the prohibition of interest denies the time value of money.

These questions need further exploration and are discussed below.

## Commercial vs. Productive Loans

It has been argued that the prohibition of *riba* in Islam was intended to apply only to consumer loans, since the institution of *riba* was used by moneylenders to exploit poor people in a time of need. The logic of the argument is that there were no organized markets for commercial and production financing and the bulk of the lending by individuals was for personal consumption. Charging *riba* on loans for consumption was deemed unfair, unjust, and exploitative, and was thus, as in other traditions, prohibited. It was felt, though, that borrowing money for productive purposes should not fall into the same category.

However, this weak argument is based on a lack of knowledge of the history of the early Islamic period. There is considerable evidence to show that lending for commercial and business ventures existed and the practice of charging interest on such loans was prevalent at the time of the prohibition. First, the practice of lending on the basis of *riba* for agricultural purposes is

well documented. Considering that the economy during that time was primarily an agricultural economy, it is reasonable to conclude that *riba*-based loans for non-consumption purposes existed and were subject to the prohibition. Second, it is a historical fact that the business community of Mecca was part of a sophisticated network of traders and it is known that some of these traders would borrow on the basis of *riba* to finance their trade expeditions. It was a common practice to raise funds to purchase local products before embarking on a trade journey. In some cases, such journeys were undertaken and financed by *riba*-based loans. The Prophet (pbuh) signed a pact with the people of Taif, who were renowned for their moneylending business, which included the condition that *riba*-based businesses be abolished. After the prohibition, the journeys continued, but were financed through partnerships rather than loans.

**Pre-prohibition Lending Practices** Siddique (1995) records the following examples of practices that were common prior to the prohibition of *riba*:

- A person would sell goods to another on the understanding that the price would be paid within an agreed period. If the price was not paid within that period, an amount was added to the price and the period of repayment was extended.
- A person would lend money to another on the understanding that a fixed additional amount would be paid besides the principal, within a fixed period.
- A rate would be agreed between borrower and lender according to which the principal, along with the additional amount, would be repaid. If a further period for repayment was required, then the rate was increased for the extended period.

There is clear and sufficient evidence that at the time of the prohibition, borrowing and lending was for both commercial and productive purposes and therefore prohibition was intended for all forms of lending.

### **Excessiveness or Compounding Only?**

As mentioned earlier, the literal meaning of the word “usury” has changed over time, from simple interest of any kind and at any level to excessive interest above a certain legal limit. This has become a source of confusion for some researchers, who take the current definition to be its original meaning and therefore come to the conclusion, wrongly, that only the charging of excessive interest is prohibited. Similarly, out-of-context interpretation of the verse in the *Qur’an* (3:130) that says “Do not devour interest doubled and redoubled,” often leads to the misunderstanding that the prohibition is for a compounded rate of interest and does not apply to other forms of simple, fair or legal rates.

In refuting the claims that prohibition was meant for excessive interest only, Muslim scholars argue that:

- The verses concerning the prohibition (2:275–81, 3:130–2, 4:161 and 30:39) do not make any distinction between exorbitant or reasonable rates of interest. The injunction in 2:279 (“... and if you repent then ye have your principal”) is a clear indication that, while the principal lent is protected, there is no such protection offered for interest at any level.
- With the help of a simple mathematical formula, it can be shown that doubling and re-doubling of the principal can take place even at a very low interest rate. For example, based on daily compounding (a common practice in today’s financial markets), a \$1 loan will be doubled in 15 years at the rate 4.6 percent.
- The prohibition of interest is associated with the notion of injustice. Researchers refer to the verse which says “... neither should you commit injustice nor should you be subjected to it” (2:279) to argue that *riba* is categorically linked in its totality with injustice and there is no mention of excessive or exorbitant rate.

### **Adjustment for Inflation or Indexation Allowed?**

While the first two issues are relatively easy to resolve, the question of any adjustment or compensation for “inflation” or “deflation” is less straightforward. The question is often raised as to whether money lent without *riba* should be adjusted for any decrease or increase of value over the period of lending. Indexation of financial obligation refers to an adjustment in value over a period of time to compensate for the change in the value arising from inflationary or deflationary pressures. Indexing wages to inflation is a widely common practice, but indexing investments or financial obligations is also growing fast in the conventional financial markets. In the case of financial assets, inflation-linked securities link the returns to the consumer price index or to the cost-of-living index. The adjustments are often in the form of *ex post* adjustments and the objective is to guarantee a return equal to the real interest rate rather than the nominal interest rate.

Indexation is justifiable in the eyes of the *Shari’ah* for wages, salaries and pensions, social security payments, and so on, but it does not support the indexation of financial assets. While some scholars argue that Islam’s notion of justice is grounds for compensation when lending without *riba*, others argue that the prohibition is absolute, pointing to the verse (2:275) that protects only the principal amount of the loan. They argue that the prohibition covers all transactions that may make any adjustments similar to *riba*, such as the deferred exchange of currency, devaluation or revaluation, and the change in the unit of currency at the time of repayment.



The lending of money is a currency transaction that is treated as being similar to the exchange of a commodity, and thus any compensation for the fall in the value of money is not justifiable.

Secondly, scholars also argue that by virtue of the presence of inflation in the economy, the investor's or lender's purchasing power would be at stake irrespective of whether money is lent as a loan on a non-*riba* basis or is invested in a return-bearing security. In either case, the net loss to the lender is a real interest rate or real return. Even if money was not lent but was kept for consumption purposes, the same loss of purchasing power would occur. Therefore, it seems unreasonable to expect the borrower to bear all the loss which is likely to occur to the lender in any case.

Thirdly, it is argued that even if some form of indexation is allowed, it may not be consonant with the notion of justice and therefore may not serve its intended purpose. While it is recognized that inflation represents a loss of purchasing power and indexation is a compensation for such loss, there are several factors that contribute to inflation and the magnitude of each factor and party cannot be determined. Therefore, it is unjust to ask one party to bear the entire burden, while others are burden-free, particularly if the borrower alone is asked to compensate for a loss which may have been caused by factors beyond the borrower's control—including, perhaps, irresponsible government policy.

In discussing the practice of indexation, some argue that there is no perfect index that can fully capture the loss of value. The constituents of the cost-of-living index may not serve as a good proxy for the loss in purchasing power. Also, the index represents the consumption habits of an average person in an economy and since the cost of living may differ from region to region and from city to city, it would not be possible to measure it accurately. This inaccuracy can lead to an unjustified transfer of wealth from the borrower to the lender or vice versa. Similarly, inflation indices are based on a lag and are therefore not readily available to be used in daily financial transactions. All these factors make indexation less practical and prone to biases, which may open a back door for unjustified charges.

*Shari'ah* scholars and economists say that price stability and fiscal discipline have to be achieved to combat inflation. In this respect, the role of the state in causing inflation should receive serious attention. Some economists argue that it is the responsibility of an Islamic state to take effective steps to check inflation in order to minimize the depreciation in the value of money. Where government policies are the source of inflation, the government should compensate the borrower.

As an alternative to indexation as a means of combating inflation, the loan could perhaps be denominated in gold: the lender could lend a certain quantity of gold to the borrower who is obligated to return the same quantity at the expiry of the loan. Other remedies might include the partnership and profit-and-loss sharing instruments of the Islamic economic system, which provide a built-in compensation for inflation because profit is shared

in an agreed ratio whereas losses are borne in the ratio of the respective capital contributions.

### **The Time Value of Money**

It is a common misconception that by prohibiting interest on loans Islam denies the concept of the time value of money. Islamic scholars have always recognized the time value of money, but maintain that the compensation for such value has its limitations. Recognition of an indirect economic value of time does not necessarily mean acknowledging any right of equivalent material compensation for this value in all cases. According to the *Shari'ah*, compensation for the value of time in sales contracts is acknowledged, but in the case of lending, increase (interest) is prohibited as a means of providing material compensation for time.

The Islamic notion of the opportunity cost of capital and the time value of money can be clearly understood by reviewing the distinction between investment and lending. Time by itself does not give a yield, but can only contribute to the creation of value when an economic activity is undertaken. A sum of money can be invested in a business venture or it can be lent for a given period of time. In the former case, the investor will be compensated for any profit and loss earned during that time and Islam fully recognizes this return on the investment as a result of an economic activity. On the other hand, if money is in the form of a loan, it is an act of charity where surplus funds are effectively being utilized to promote economic development and social well-being.

In response to the contemporary understanding that interest on a loan is a reward for the opportunity cost of the lender, Islamic scholars maintain that interest fixed *ex ante* is certain, is tantamount to indulging in *riba* and is therefore unlawful. The element of uncertainty diminishes with time and the resultant return on investment is realized, rather than the accruing of return due to the passage of time. In short, Islam's stand on the time value of money is simple and clear. Money is a medium of exchange; time facilitates completion of economic activity, and the owner of capital is to be compensated for any return resulting from economic activity. Lending should be a charitable act without any expectation of monetary benefit.

### **RATIONALE FOR THE PROHIBITION OF *RIBA***

The fundamental sources (the *Qur'an* and the *sunnah*) do not provide any detailed rationale for the prohibition of *riba* beyond asserting, axiomatically, that charging interest is an act of injustice. Contemporary Muslim scholars, particularly the economists among them, have provided various rationales for this prohibition by alluding to the consequences of the existence of interest in modern societies, or by arguing that modern economic theory has not provided any justification for the existence of even the necessity of interest

rates. Some also argue that human wisdom and comprehension are limited compared to the knowledge of Allah (*swt*) and therefore any exercise to fully understand the rationale of the prohibition may not yield any optimal comprehension.

### ***Riba* and Economic and Social Injustice**

One of the primary and the most frequently articulated rationales for the prohibition is that the existence of *riba* in the economy is a form of social and economic exploitation, which violates the core Islamic teaching of social justice. Therefore, the elimination of interest from the economic system is intended to promote economically just, socially fair, and ethically and morally correct economic behavior.

The logic as to why the *Qur'an* has given such a severe verdict against interest is that Islam is against all forms of exploitation and is for an economic system that aims to secure extensive socio-economic justice. Islam condemns all forms of exploitation, particularly the injustice continued in the form of a lender being guaranteed a positive return without assuming a share of the risk with the borrower, who takes upon himself all sorts of risks in addition to contributing his skills and labor. Considering that the wealth an individual possesses is actually a trust held for Allah (*swt*), like a person's life (also a trust from the Creator) the trust of wealth is sacred as well.<sup>2</sup> Then, if that wealth is taken unjustly, an injustice is done to the sanctity of a human being.

The existence of *riba* is not compatible with Islam's value system, which prohibits any form of "unjustified" enrichment (*akl amwal alnas bi al-batil*). By eliminating *riba*, each party to the contract gets a fair and equitable reward, which ultimately leads to more equitable returns and distribution and therefore to a more just economic system.

### ***Riba* Violates Islam's Principles of Property Rights**

The *Qur'an* clearly and strongly condemns the acquisition of the property of others through wrongful means (see 2:188, 4:29, 4:161 and 9:34). Islam recognizes two types of individual claims to property: (a) the property rights that are a result of the combination of an individual's labor and natural resources, and (b) rights or claims to the property that is obtained through exchange, remittances of what Islam recognizes as the rights of those less able to utilize the resources to which they are entitled, outright grants, and inheritance. Money represents the monetized claim of its owner to the property rights created by assets that were obtained or received through either or both of these avenues. Lending money is, in effect, a transfer of these rights from the lender to the borrower and all that can be claimed in return is its equivalent and no more. Interest on money loaned represents an unjustifiable and instantaneous property rights claim. It is unjustifiable because

interest is a property right that falls outside the legitimate framework of individual property rights recognized by Islam. Such a claim is instantaneous because a right to the borrower's property is created for the lender as soon as the contract for lending is concluded, regardless of the outcome of the enterprise for which the money is used.

Money lent on interest is used either productively, in the sense that it creates additional wealth, or unproductively, in the sense that it does not lead to incremental wealth produced by the borrower. In the former case—when the funds are used in combination with the labor of the entrepreneur to produce additional wealth—the money lent cannot have any property rights claim to the incremental wealth because the lender, when lending money, does not bargain for a proportion of the additional wealth but for a fixed return, irrespective of the outcome of the enterprise. He, in effect, transfers the right to his property to the borrower. In the latter case, since no additional wealth, property or assets are created by the borrower, the money lent—even if legitimately acquired—cannot be used to claim any additional property rights since none is created.

## **PROMOTING PROFIT AND RISK SHARING**

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When the Arabs argued that “trade is but like *riba*” (2:275), they were decisively informed that “Allah has permitted trade and forbidden *riba*.” The legal differences between trade and *riba* as set out in the *Qur'an* have been detailed over the centuries by capable Muslim jurists. However, the fact remains that the sophisticated Arab traders of Mecca did not at first see any discernible difference between the Islamic model and the one based on *riba*. The sharing of the enterprise's risks and uncertainties is an extremely important characteristic of Islamic financial contracts. The *Shari'ah* condemns even a guarantee by the working partner to restore the invested funds intact, not only because it removes the element of uncertainty needed to legitimize the agreed distribution of expected profits, but also because the lender will not be remunerated to the extent of the productivity of his financial capital in the resulting profit.

In Islam, the financial instruments for trade and production purposes are based on risk/profit sharing as a return for the entrepreneurial effort and on financial capital. The lender who advances money for trade and production can contract to receive a share of the profit. In doing so, he becomes part-owner of the capital of the enterprise and shares in its risk. As a shareholder in the enterprise, he becomes liable for its debts to the extent of his investment, and receives a return (a dividend) only when a profit is earned. A creditor, on the other hand, as a debenture holder, lends money without the risk of owning and operating capital goods and claims interest regardless of the profit or loss position of the enterprise. The creditor runs a risk, but it is the risk of the solvency of the borrower, not of the success or failure of the enterprise.

## **LACK OF THEORY OF INTEREST**

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Islamic scholars advocating the elimination of interest from the economy highlight the fact that there is no satisfactory theory of interest in the conventional economic theory. This criticism is especially leveled against having a fixed rate of interest. Muslim writers see the existing theories of interest as attempts to rationalize the existence of an institution that has become deeply entrenched in modern economies and not as attempts to justify, based on modern economic analysis, why the moneylender is entitled to a reward on the money he lends.

Typical justifications for interest in any economy include the arguments that interest is a reward for saving, a marginal productivity of capital, and an inevitable consequence of the difference between the value of capital goods today and their value after some time. With such arguments in mind, the following points can be made:

- To the argument that interest is a reward for saving, Muslim scholars respond that such payments could only be rationalized if savings were used for investment to create additional capital and wealth: the mere act of abstention from consumption should not entitle anybody to a return.
- The response from Muslim scholars to the argument that interest is justified as marginal productivity of capital is that although the marginal productivity of capital may enter as one factor into the determination of the rate of interest, interest, per se, has no necessary relation with the productivity of capital. Interest, they argue, is paid on money, not on capital, and has to be paid irrespective of capital productivity. In distinguishing between interest as a charge for the use of money and a yield from the investment of capital, they argue that it is an error of modern theory to treat interest as the price of, or return on, capital. Money, they argue, is not capital, it is only “potential capital,” which requires the service of the entrepreneur to transform the potentiality into actuality; the lender has nothing to do with the conversion of money into capital or with using it productively.
- To the argument that interest arises as the time value of money, Muslim scholars respond that this only explains its inevitability and not its “rightness.” Even if the basis for time preference is the difference between the value of commodities this year and the next, it seems more reasonable to allow next year’s economic conditions to determine the extent of the reward.

It is argued that when a person lends funds, the funds are used to create either a debt or an asset (that is, through investment). In the first case, Islam considers that there is no justifiable reason why the lender should receive a return simply through the act of lending per se. Nor is there a justification, either from the point of view of the smooth functioning of the

economy, or that of any tenable scheme of social justice, for the state to attempt to enforce an unconditional promise of interest payment regardless of the use of borrowed money. If, on the other hand, the money is used to create additional capital wealth, the question is raised as to why the lender should be entitled to only a small fraction (represented by the interest rate) of the exchange value of the utility created from the use made of the funds; the lender should be remunerated to the extent of the involvement of his financial capital in creating the incremental wealth.

### **Sub-optimality of Debt-based Investments**

Some researchers have attempted to explain the prohibition of interest and debt by comparing risk for a given investment financed exclusively by equity with risk for the same investment if it is financed by a mix of debt and equity. Iqbal (2010) notes that risk aversion can be seen as rational human behavior in both conventional and Islamic economics. In conventional economics, this is evident from the extensive use of the Expected Utility Hypothesis (EUH) in decision-making under uncertainty and of Modern Portfolio Theory (MPT) in the selection of financial instruments. Both EUH and MPT are exclusively based on a risk-averse attitude. In Islamic economics, strong condemnation of *mysir* (games of chance, including gambling) and *gharar* (excessive uncertainty about the price, quantity or quality of a commodity or service) lends support to the conclusion that risk aversion is acknowledged as rational human behavior.

Therefore, the author sets the null hypothesis as the variance of a given investment is less if it is financed exclusively on a PLS-basis than that if it is financed by a mix of debt and equity. An investment's future profit or loss outcomes are probabilistic and, therefore, its expected cashflows remain the same whether it is financed exclusively by equity or by a mix of debt and equity as stated in the Miller-Modigliani (MM) theorem of irrelevance of capital structure. However, its variance comes out greater if it is financed by any mix of debt and equity rather than by equity exclusively. Furthermore, its variance increases by a greater margin corresponding to every similar increase in the debt-equity ratio.

The hypothesis is proved mathematically assuming a fixed interest rate, irrespective of its magnitude, in the case of debt financing. The mathematical exercise also shows that similar increases in the debt-equity ratio add to the investment risk posed to a shareholder proportionately more than they add to his/her expected return. Moreover, successive increases in debt financing multiply the bankruptcy risk of underlying investment without affecting its overall return. This means that debt financing minimizes risk for individual lenders, and adds a bankruptcy risk on top of uncontrollable natural risk for underlying investments, leaving its expected return unchanged. The Iqbal (2010) study shows that the risk for a given investment is smaller if it is financed exclusively by equity rather than by a mix of debt and equity. This means that, where interest is permitted, a 1 percent

increase in the debt–equity ratio in the financing of a given investment increases its risk at an increasing rate without increasing its overall expected return. This is probably the consequence of the fact that financing an investment exclusively by means of debt is not observed even in the conventional system where leverage is encouraged.<sup>3</sup>

An important implication of this study is that if prohibition of interest is taken as a restriction on personal liberty without keeping in view the negative macroeconomic externality that it generates in the form of increasing risk to the underlying investment, then it seems dogmatic and coercive. However, if the negative externality of debt financing and its exploding nature is fully understood, prohibiting interest makes more economic sense than permitting it.

### The Act of Lending is an Act of Charity

Many Muslim scholars point out that Islam's prohibition of *riba* has two dimensions: to promote more equitable risk-sharing contracts for business and commercial purposes; and to consider lending as a benevolent act with a view to helping someone in need. If someone needs capital for commercial purposes, then capital should be given on a risk-sharing basis and if someone needs funds to overcome some short-term need, then such need should not be exploited and the borrower should not be put under an undue burden. The benevolence and philanthropic elements of the prohibition of *riba* are supported by the *Qur'an* and the traditions of the Prophet (pbuh).

The *Shari'ah* considers a loan to be a gratuitous contract, encourages Muslims to offer charitable loans (*qard-ul-hassan*), and condemns the accumulation of wealth for its own sake. Granting a loan without *riba* is considered a charitable act worthy of bringing blessings (*barakah*); conversely, lending on the basis of *riba* has far-reaching and less-favorable consequences.<sup>4</sup> Economists argue that acts of charity can play a critical role in economic development.

### Other Prohibited Elements

**Gharar** After *riba*, *gharar* is the most important element in financial contracts. In simple terms, *gharar* stems from informational problems and refers to any uncertainty created by the lack of information or control in a contract. It can be thought of as ignorance in regard to an essential element in a transaction, such as the exact sale price, or the ability of the seller to actually deliver what is sold. The existence of *gharar* in a contract makes it null and void.

*Gharar* can be defined as a situation when either party to a contract has information regarding some element of the subject of the contract, which is withheld from the other party, and/or the subject of contract is something over which neither party has control. Classic examples include transactions involving birds in flight or fish not yet caught, an unborn calf in its mother's

womb, or a runaway animal. All such cases involve the sale of an item that may or may not exist. More modern examples include transactions where the subject is not in the possession of one of the parties and there is uncertainty even about its future possession.

Keeping in mind the notion of fairness in all Islamic commercial transactions, the *Shari'ah* considers any uncertainty as to the quantity, quality, recoverability, or existence of the subject matter of a contract as pointing to the element of *gharar*. However, it leaves it to the jurists to determine the extent of *gharar* in a transaction and, depending on the circumstances, it may or may not invalidate the contract. By prohibiting *gharar*, the *Shari'ah* prohibited many pre-Islamic contracts of exchange on the grounds that they were either subject to excessive uncertainty or were not known to one or both parties to the contract, causing unnecessary disputes and injustice. In many cases, *gharar* can be eliminated from contracts by carefully stating the object of the sale and the price in order to remove unnecessary ambiguities. A well-documented contract will eliminate *gharar* as well.

Viewed as excessive uncertainty, *gharar* can be associated with the element of risk. Some argue that prohibiting *gharar* is one way of managing risks in Islam, as a business transaction based on profit-and-loss sharing will encourage parties to conduct due diligence before committing to the contract. Prohibition would force parties to avoid contracts with a high degree of informational asymmetry and with extreme payoffs, and would make them more responsible and accountable. However, treating *gharar* as risk has its consequences. In prohibiting *gharar*, the *Shari'ah* is also prohibiting the trading of it, thus also prohibiting of the use of derivative instruments designed to transfer risk from one party to another in today's financial markets.

The prohibition of *gharar* by implication includes the prohibition of pure speculation and gambling activities, which involve asymmetric information, excessive uncertainty, risk and lack of control. Although some of the earlier researchers raised concerns about the permissibility of trading in the stock markets on the ground that it amounted to speculation, the stock market is based on some fundamental analysis of economic variables and is subject to a reasonable level of uncertainty rather than pure speculation. The prohibition of *gharar* has also raised concerns in the area of insurance. Some argue that writing an insurance contract on the life of a person falls within the domain of *gharar* and thus invalidates the contract. The issue is still under review and has yet to be fully resolved.



## APPENDIX **A**

# **Usury, *Riba* and Interest: A Historical Perspective**

**A** historical review of the term “usury” brings to light and explains a consistent pattern of prohibition of interest. Usury was defined originally as “charging a fee for the use of money,” irrespective of the level of interest charged. After moderate-interest loans became an accepted part of the business world in the Middle and early-Modern Ages, the word “usury” came to refer to the charging of unreasonable or above-legal rates of interest. According to the Oxford English Dictionary, the term took on this new meaning somewhere between the sixteenth and seventeenth centuries, a meaning it has retained to this day.

The practice of lending money on interest can be traced back approximately four thousand years. Since its earliest incarnations, the practice has been repeatedly condemned, restricted or prohibited on moral, ethical, religious, and legal grounds by various traditions, institutions, and social reformers. The rationale employed by these wide-ranging critics has included arguments about work ethic, social justice, economic instability, and inter-generational equity. Among the religious traditions, the explicit and implicit prohibition of interest is mentioned in Hinduism, Buddhism, Judaism, Christianity and Islam.

The Greek philosopher Aristotle considered money as a means to facilitate exchange and therefore was of the view that a piece of money could not beget another piece. He rejected the justification for charging interest on this ground, arguing that money is sterile. In the Vedic Hindu texts of Ancient India (2000–1400 BC), there are several references to the “usurer” (*kusidin*) as any lender at interest. Further references to “interest” can also be found in the later Sutra texts (700–100 BC), as well as in the Buddhist Jatakas (600–400 BC). It was during this latter period that the first sentiments of contempt for usury were expressed. According to Jain (1929), Vasishtha, a well-known Hindu law-maker of that time, made a special law which forbade the higher castes of Brahmanas (Hindu priests) and Kshatriyas (warriors) from being usurers or lenders at interest. In the Jatakas, usury is

referred to in a deprecating manner, claiming that “hypocritical ascetics are accused of practicing it.”

## JUDAISM AND INTEREST

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In Judaism, the Old Testament clearly disallowed dealing with interest as implied by the Hebrew word “*neshekh*” (literally, “a bite”). Similar to *riba*, *neshekh* referred to any gain, whether from the loan of money or goods or property of any kind. While it was not defined explicitly, it was commonly referred to as the practice of the exaction of interest from the debtor by the creditor. In the books of Exodus (22:25) and Leviticus (25:36 and 37), the term applies to lending to the poor and destitute, while in Deuteronomy (23:19–20), the prohibition is extended to include all money lending, excluding only business dealings with foreigners. In addition to the direct mention of interest, there are several references to derivatives—or indirect interest, known as *avak ribbit*, literally “the dust of interest”—which apply, for example, to non-financial transactions and include certain types of sales, rent agreements and work contracts.

## CHRISTIANITY AND INTEREST

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In Biblical times, all payments for the use of money were forbidden. There are several references to prohibition of an increase on the amount lent out. Charging interest was condemned throughout the early history of Christianity. In *The Divine Comedy*, Dante places the usurers in the inner ring of the seventh circle of hell, below even suicides.

By the second century AD, usury had become a more relative term which meant charging interest beyond the legal rate, but that did not prevent the Church from continuing to condemn the practice. By the fourth century, the Roman Catholic Church maintained its prohibition on the taking of interest by the clergy and this rule was extended to the laity in the fifth century. In the eighth century, under Charlemagne, the Church declared usury to be a general criminal offence. During Medieval times, lending was considered a gratuitous act and lending on interest was morally wrong. In the early Middle Ages, Popes and Councils continued to oppose all forms of payments for the use of money lent, as money was mainly for the purpose of exchange and its principal use was its consumption. This anti-usury movement continued to gain momentum during the early Middle Ages and, in 1311, Pope Clement V made the ban on usury absolute and declared all secular legislation in its favor null and void.<sup>5</sup>

The end of the thirteenth century saw the decline of the influence of the Orthodox Church and the rise of secular powers and, as a result, despite the Church’s clear prohibition, the practice of charging interest gained some acceptance and tolerance. During the Mercantile Era (1500–1700 AD),

when money began to play a critical role in large-scale commercial transactions and was treated as capital, there were arguments that equated interest with rent on capital, similar to the charging of rent for physical factors of production. With the emergence of the Protestant Reformation and the rise of capitalism, usury was accepted on the grounds that it was sinful only if it hurt one's neighbor, and that was a matter for each individual to determine.

Thus, factors such as changing business practices, the rise of capitalism and pro-usury movements such as the Reformation, led, sometime around 1620, to the practice of usury making a transition from being an offence against public morality, which a Christian government was expected to suppress, to being a matter of private conscience. At the same time, a new generation of Christian moralists redefined usury as excessive interest. For example, the teachings of John Calvin (1509–64) led to the emergence of the Calvinist bankers in Geneva, who were free to develop their financial interests without any feelings of guilt, provided that they observed the Christian teaching on justice to the poor, and that they were totally honest in their dealings. The Catholic Church, however, continued its opposition to usury. In 1740, for example, the Pope vehemently condemned a bond issued at a low rate of 4 percent by the city of Verona. This also indicates that as late as the eighteenth century, the Christian understanding of usury was that it included any form and level of interest and did not refer to excessive interest alone.

### **Prohibition of Usury in the Bible**

In addition to the above-mentioned scriptures in the Judaic tradition, Christians could point to many other texts from the Old Testament to justify the view that usury in all its forms was forbidden. These include:

“He that by usury and unjust gain increaseth his substance, he shall gather it for him that will pity the poor.” (Proverbs 28:8)

“He that putteth not out his money to usury, nor taketh reward against the innocent. He that doeth these things shall never be moved.” (Psalm 15:5)

“Woe is me, my mother, that thou hast borne me a man of strife and a man of contention to the whole earth! I have neither lent on usury, nor men have lent to me on usury [interest]; yet every one of them doth curse me.” (Jeremiah 15:10)

“He that hath not given forth upon usury, neither hath taken any increase, that hath withdrawn his hand from iniquity, hath executed true judgment between man and man . . .” (Ezekiel 18:8)

“In thee have they taken gifts to shed blood; thou hast taken usury [interest] and increase, and thou hast greedily gained of thy neighbors by extortion, and hast forgotten me, saith the Lord God.” (Nehemiah 5:7) and

“Then I consulted with myself, and I rebuked the nobles, and the rulers, and said unto them, Ye exact usury [interest], every one of his brother. And I set a great assembly against them.” (Ezekiel 22:12).

## ISLAM AND INTEREST

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The practice of *riba* was prevalent at the dawn of Islam and when the prohibition was proclaimed, it did not require any further clarification.<sup>6</sup>

As we have seen throughout this book, several verses of the *Qur'an* mention and prohibit *riba*. So explicit and clear was this prohibition that its meaning was rarely challenged. With the introduction of debt securities and commercial banking, which further strengthen the institution of interest, the question has been raised more frequently in modern times. Muslim scholars have always maintained that interest constitutes *riba* and is therefore prohibited. As with Judaism and Christianity, from time to time there have been attempts to justify the practice. Throughout Islamic history, questions regarding interest have been posed to *Shari'ah* scholars and they have predominantly upheld the prohibition. However, in rare cases, there have been exceptions in the form of minority opinions, which often did not last long. Such minority opinions were often given under political influence or were born of a lack of understanding—either of the traditional Law or of the contract in question.

More recently, in 1989 a legal opinion (*fatwa*) issued by Egypt's highest legal scholar, Sheikh al-Azhar Muhammad Sayyid al-Tantawi, gave rise to considerable controversy. His opinion, that banks may fix the rate to be paid to depositors, was supported by the prestigious seminary the Al-Azhar Islamic Research Institute. While the legal opinion may have been valid for a specific situation, it was never intended to lead to a general acceptance of the practice of paying or receiving bank interest. Unfortunately, the banking industry took the opinion as an excuse to claim that interest was permissible. The same legal opinion resurfaced in late 2002, but was immediately refuted by the Council of Islamic Jurisprudence Academy, which categorically declared all forms of bank interest illegal from the *Shari'ah's* point of view. In both cases, the attempts to justify bank interest were met with strong opposition and rejection, with the majority of *Shari'ah* scholars upholding the prohibition.

## INTEREST AND MODERN ECONOMICS

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The majority of modern economists accept the institution of interest as an essential ingredient of the modern economic system. However, from time to time, the notion of charging interest on money is challenged. Silvio Gesell, a successful merchant during the early years of the twentieth century, condemned interest on the basis that his sales were more often related to the price of money (that is, interest) than to consumers' needs or the quality of his products. His proposal of making money a public service subject to a use fee was not welcomed by the banking community and therefore did not gain any popularity. More recently, the German economist Margrit Kennedy has

criticized the institution of interest and has advocated interest- and inflation-free money. Overall, however, critics of interest are rare exceptions among modern economists.

The challenge has come mainly from Islamic scholars. Sheikh Mahmud Ahmad, for example, searched through several theories of interest, developed since the time of Adam Smith, to show that there has been no satisfactory explanation of the existence of a fixed and predetermined rate of return on financial assets. His analysis of the writings of economists such as Keynes, Bohm Bowerk, Cassels, and Samuelson led him to argue that an objective assessment of these writings would lead to the belief that all of these writers held a reasonably strong conviction that the existence of a fixed and predetermined rate of interest was an impediment to the process of economic growth and development.

By the mid-1980s, economic and financial theory had demonstrated that there were disadvantages in the fixed payoff contracts that dominated interest-based banking. It was shown that such contracts create inefficient defaults on financial obligations or non-performing assets. In the presence of asymmetric information, debt contracts also suffer from the effects of adverse selection and moral hazard. Fixed-fee contracts create a fundamental conflict between the interests of the borrowers and the lenders.

As a consequence, socially desirable sectors with low profitability will not get finance; moreover, new entrepreneurs with good projects may not be able to obtain finance in the absence of the security required.

## ENDNOTES

1. Lane's Lexicon defines it this way: "To increase, to augment, swellings, forbidden 'addition', to make more than what is given, the practicing or taking of usury or the like, an excess or an addition, or an addition over and above the principal sum that is lent or expended."
2. According to one of the sayings of the Prophet Mohammad (pbuh), "a person's wealth is as sacred as a person's blood."
3. Excessive leverage is observed in financial institutions and hedge funds but it has been criticized in the wake of the financial crisis of 2007–08. Therefore, ignoring all debt financing is a reasonable assumption.
4. See, for example, the *Qur'an* 30:39, 57:11 and 64:17. The Prophet (pbuh) is also reported as saying that "debauchery and *riba* lead a nation to ruin."
5. Birnie (1952).
6. A minor incident in 605 AD, just a few years before the revelation of Islam, is worth mentioning. The sacred House of God, Kabbah, was damaged by fire and public contributions were called for to repair the damage. However, it was emphasized that only pure, clean, and honestly earned money could be used for this purpose and consequently prostitutes and usurious moneylenders were specifically debarred from contributing. This incident is an indication that even the pagans of Arabia did not consider money earned through lending to be from a clean and ethical source.

## CHAPTER 4

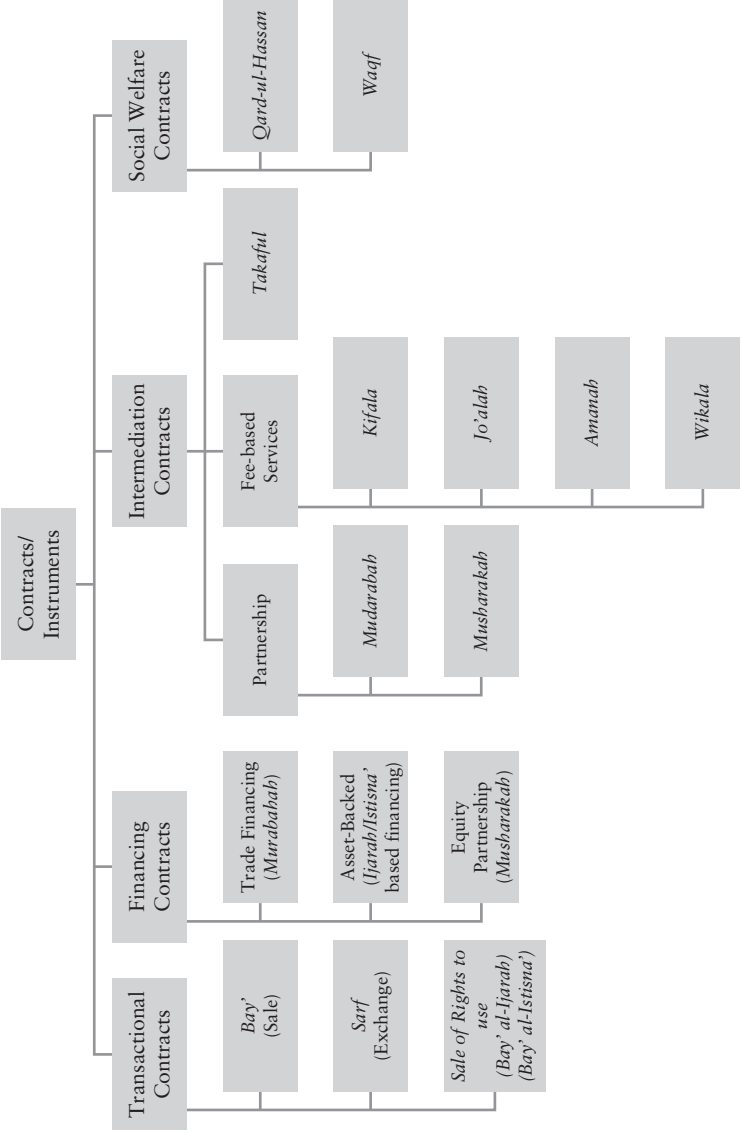
# Financial Instruments

**T**he economic activities in any economic system can be viewed as contracts between economic agents. A financial instrument is also a contract, whose terms and conditions define the risk-and-return profile of the instrument. The whole fabric of Divine Law in Islam is contractual in its conception, content and application. Islam forcefully places all economic relations on the firm footing of “*contractus*”—as discussed in Chapter 2. The preservation of property rights and the commitment to obligations and responsibilities associated with a contract are vital in determining the standards of behavior expected of the economic agents and, ultimately, the nature of the economic system in Islam.

In Islam, a contract is deemed legal and lawful by the *Shari’ah* if the terms of the contract are free of any prohibition. In other words, if a contract does not have or involve any of the prohibited elements, such as *riba* or *gharar*, and does not violate any other rule or law it is considered valid. For example, although a contract to invest in a company producing alcohol may be free of *riba* and *gharar*, it would still be invalid in the eyes of the *Shari’ah*, since it deals with the production of alcohol, which is prohibited in Islam. Several commercial contracts have their roots in the pre-Islamic period but have been further developed and widely practiced after their compatibility with the principles of *Shari’ah* was ascertained and confirmed.

The Islamic economic system has a set of core contracts, which serve as building blocks for designing more sophisticated and complex financial instruments.<sup>1</sup> There is no established classification of contracts in the Islamic legal system as such, but from a business and commercial point of view, certain contracts can be grouped together according to their function and purpose in the economic and financial system. Contracts dealing with commercial and business transactions can be classified into four broad categories as shown in Figure 4.1.

This demarcation and classification based on the function and purpose of contracts give us a framework to understand the nature of credit creation, types of financing instruments, intermediation and the different roles each group plays in the economic system. In other words, theoretically, Islamic commercial law would be able to satisfy the needs of economic agents



**FIGURE 4.1** Contracts/Instruments

through various phases of economic activity, right from the purchase or sale of goods, to arrangements for collateral and guarantees, to arrangements for credit or finance and finally to the creation of opportunities for investment.

**Transactional contracts** deal with the real-sector economic transactions that facilitate the exchange, sale and trade of goods and services. The core transactional contracts are based on trade- or exchange-based activities. Exchange could be on the spot or on a deferred basis and could be of goods for goods, or of goods for price, or goods for promise to pay. These contracts create assets, which further become the basis of financing and investment opportunities; thus they form the very core of an extended economic and financial system.

**Financing contracts** offer ways to create and extend credit, facilitate financing of transactional contracts, and provide channels for capital formation and resource mobilization between investors and entrepreneurs. The distinguishing feature of such financing contracts is the absence of a debt contract. Financing contracts are meant either for the financing of transactional contracts in the form of trade finance or asset-backed securities, or for providing capital through equity partnerships, which can take several forms, such as partnership, co-ownership, or diminishing partnership.

The role of **intermediation contracts** is to facilitate an efficient and transparent execution of transactional and financial contracts. Intermediation contracts provide the economic agents with a set of tools to perform financial intermediation as well as to offer fee-based services for economic activities. These contracts include *mudarabah* (a trustee finance contract), *musharakah* (equity partnership), *kifala* (guarantee), *amanah* (trust), *takaful* (insurance), *wakalah* (agency) and *jo'alah* (fee-based service). In a *mudarabah* contract, an economic agent with capital (*rabbal-mal*) can form a partnership with another agent with skills (*mudarib*), with an agreement to share the profits. Although losses are borne by the capital owner only, the *mudarib* may be liable for a loss resulting from any misconduct or negligence on his part. Intermediation contracts are discussed in detail in the next chapter on financial intermediation.

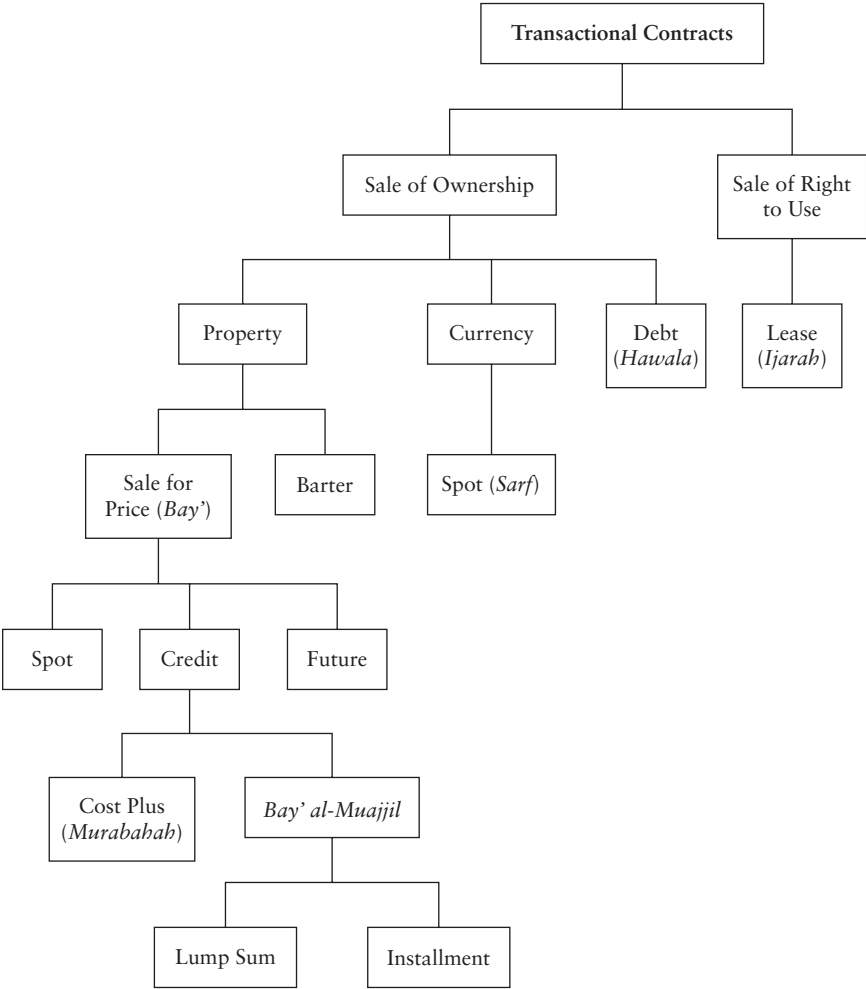
Finally, **social-welfare contracts** are contracts between individuals and the society to promote the well-being and welfare of the less privileged. Although facilitation of such contracts is beyond the scope of intermediation, an intermediary can certainly offer community services by institutionalizing social-welfare contracts.

## **TRANSACTIONAL CONTRACTS**

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Islam lays great emphasis on promoting trade and gives preference to trading over other forms of business. Trade incorporates not only the trading of physical assets but also of the rights to use those assets. The basic contracts are therefore the contracts of exchange, sale of an asset or sale of rights to utilize an asset. Whereas contracts of exchange and sale result in the transfer





**FIGURE 4.2** Transactional contracts

of ownership, contracts for the utilization of assets transfer only the right to use a property from one party to another. These two types of contracts, from which all others derive, lay the foundation of the principal commercial activities in the economy. Figure 4.2 shows the hierarchy of transactional contracts.

**Contracts of Exchange and Sale**

A contract of exchange is primarily concerned with trading, as well as selling and buying activities and their derivatives such as cash sales, deferred-payment sales, deferred-delivery sales, sales on order, debt and currency,

auction sales, and so on. Contracts of exchange include a variety of contracts, which differ from one another in their specific legal requirements, rights, obligations and liabilities, but have a similar result; namely, the transfer of ownership from one party to another. There are specific rules for the exchange of specific types of assets; for example, exchanges of currency and debt can only take place on the spot and any deferment of exchange or payment is not allowed.

There is no concrete way to classify the contract of sale, but it can be viewed from different angles, depending on the underlying asset and/or the modes of payment and delivery. When sale contracts are viewed considering the subject of sale or the underlying asset, sale can be of five types:

- (i) *Bay'*—sale of a property or commodity (moveable or immovable) to another person for a price
- (ii) *Sarf*—sale by exchange of money for money on the spot
- (iii) Sale by barter—exchange of goods for goods, in which neither is a money payment
- (iv) *Bay' al-dayn*—sale of debt or liability
- (v) *Bay' al-salam* (sale by immediate payment against future delivery) and *Bay' al-istisnah* (sale on order). The main feature of such sales is that the item for sale is yet to come into existence at the time of the contract.

Similarly, when viewed from the point of view of the mode of payment, sales contracts fall into the following categories:

- (i) Spot cash sale: The purchaser is under an obligation to pay the agreed purchase price at the time of concluding the contract
- (ii) Installment sale: Where payment is deferred and is to be made in installments
- (iii) Lump sum payment payable in the future: This mode of payment is valid if the date of payment is predetermined and is applicable to all types except *bay' al-salam*.
- (iv) *Bay' al-arabun*: Here, a portion of the full sale price is paid in good faith as earnest money. If the buyer decides not to complete the sale, this advance payment is forfeited to the seller.

In some cases, the sales contract can result in a credit sale where the payment is deferred, but there is a cost involved in deferring the payment. Such contracts (*murabahah*) are discussed in more detail later.

- (v) Deferred payment contracts (*bay' al-muajjal*): This contract allow for the payment for a product in installments or in a lump sum. The price of the product is agreed between the buyer and the seller at the time of the sale and cannot include any charges for deferring payments.

***Bay' al-salam (Purchase with Deferred Delivery)*** *Bay' al-salam* contracts are similar to conventional forward contracts in their function, but have different payment arrangements. The buyer pays the seller the full negotiated price of a

specific product which the seller promises to deliver at a specified future date. However, unlike with a conventional forward contract, the full price is payable at the time of the contract. This forward sale is beneficial to both the seller and the buyer. The seller gets cash to invest in the production process and the buyer eliminates the uncertainty in the future price.

*Bay' al-salam* was permitted as a special case by the Prophet (pbuh) because pre-payment of the price allowed farmers to buy seeds and raw materials, and for personal consumption in order to be able to produce the fruits and crops. The prohibition of *riba* meant that farmers and traders could not take usurious loans and, therefore, they were permitted to sell agricultural products in advance. Similarly, the traders of Arabia who were engaged in importing and exporting goods were permitted to sell their goods in advance as a means of financing business.

The permissibility of *bay' al-salam* was an exception to the general rule that prohibits forward sales. Therefore, it was subjected to some strict conditions, such as the following:

- The transaction was limited to products whose quality and quantity could be fully specified at the time the contract was made. If the quality or quantity of a product could not be so specified, it could not be sold through the *bay' al-salam* contract. For example, precious stones would not qualify, since no two pieces were the same, either in quality or in size or weight and their exact specification was not generally possible.
- Full payment of the purchase price was due at the time of the contract. If payment was not made, it could be misused to create a debt for the sake of selling a debt against debt, which is prohibited.
- The exact date and place of delivery had to be specified in the contract.
- It was permissible to take a mortgage and a guarantor on a *bay' al-salam* obligation to guarantee that the seller performed the obligation to deliver the commodity on the due date.
- The commodity intended to be sold had to be in the physical or constructive possession of the seller.

In the modern economy, *bay' al-salam* can be utilized for several purposes, particularly for the financing of agricultural operations, where the farmers can go through a financial intermediary such as an Islamic bank to buy or sell the produce in the forward market. The bank makes a valuable contribution to economic development by providing financing to farmers and a hedge against price volatility to the users of the produce. In the case of commercial and industrial activities, the use of this contract can help finance small-medium enterprises (SMEs) in providing necessary capital to buy inputs and raw material for the production process.

***Ijarah (Lease)*** Technically, an *ijarah* contract is a contract of sale, but it is not the sale of a tangible asset; rather, it is a sale of the *usufruct* (the right to use the object) for a specified period of time. The word “*ijarah*” conveys

the sense of both hire and lease. In general, it refers to the lease of tangible assets such as property and merchandise, but it is also meant to denote the hiring of personal services for a fee. Renting an asset also comes under the contract. In such cases, the asset is leased for a much shorter period than its actual useful life, which also means that the asset can be rented to multiple users over its life.

Compared to the conventional form of financing, which is generally in the form of debt, leasing results in financing against a particular asset. In a sense, it combines financing and collateral, because the ownership of the asset serves as collateral and security against any future loss. The title to the ownership of the asset remains with the lessor who, in the case of default, can repossess the equipment. In addition, the financing is not dependent on the capital base of the lessee but depends on their creditworthiness to service the rental cash-flow payments.

While the function of the *ijarah* resembles that of the conventional lease agreement, there are some differences between the two. With the *ijarah*, the leasing agency must own the leased object for the duration of the lease. Another difference is the absence of compound interest that may be charged under conventional leases in the event of default or delay in the installment payments. Similarities with conventional leasing make this contract attractive to conventional investors and borrowers as well.

### *Features and Conditions*

- **The Lessor's Responsibilities:** The lessor must be the owner of the asset to be leased. It is the responsibility of the lessor/owner to maintain the property leased, so that it continues to generate benefit for the lessee. The lessor is expected to protect the property by arranging for adequate insurance against any loss or damage to the asset. The lessor/owner is responsible for certain costs and liabilities arising from leasing, such as damage to the asset, payment of any insurance premium costs and basic maintenance. While the cost must be borne by the lessor/owner, for the sake of efficiency, the lessor/owner may authorize the lessee to administer it on his/her behalf.
- All terms of the *ijarah* contract should be stipulated in detail. These terms include the asset being leased, the rental amount, the payment schedule and the purpose for which the asset may be used.
- The leased asset should be treated as a trust in the hands of the lessee.
- The contract is intended for the utilization of the asset and not for its consumption. Therefore, the contract specifies that the object leased must not be perishable or consumable.
- In case of any default by the lessee in making rental payment, the lessor is entitled to revoke the contract and claim the contract price for the remaining period.<sup>2</sup> The lessor/owner may claim compensation for any damage caused to the leased assets as a result of negligence on the part of the lessee.

Recently, Muslim jurists have also provided another contract, *ijarah wa "qtina"* or "hire-purchase agreement," which is similar to the conventional lease-purchase agreements. In addition to the regular *ijarah* contract, this includes a promise by the lessor/owner to sell the leased asset to the lessee at the end of the original lease agreement. The price for the residual value of the asset is predetermined. The second contract thus gives the lessee the option to purchase the asset at the conclusion of the *ijarah* contract or simply return it.

The *ijarah* contract has great potential for developing advanced financial instruments to meet the demands of investors and entrepreneurs. One of the main attributes of leasing practiced today is that the rental flows can be either a fixed amount or a floating amount, which makes it suitable for the different needs of investors. Leasing constitutes a large portion of the portfolios of Islamic banks. However, this share could be higher. One of the reasons why Islamic banks do not increase their lease portfolio is that by becoming the lessor/owner of the asset, they take on additional responsibilities for administering the lease, which is not their main business.

An *ijarah*-based model to provide mortgages for housing is already operating in North America. In addition, the *ijarah* contract has been used in the successful launch of Islamic bonds (*sukuk*), which are discussed further in Chapter 8.

***Istisna'* (partnership in manufacturing)** The *istisna'* contract is suitable for facilitating the manufacture or construction of an asset at the request of the buyer. Once the manufacturer undertakes to manufacture the asset or property for the buyer, the transaction of *istisna'* comes into existence. Both parties (namely, the buyer and the manufacturer) agree on the specifications and price of the asset to be manufactured. At the time of delivery, if the asset does not conform to the specifications, the party placing the order has the right to retract the contract.

One of the important features of *istisna'* is the flexibility it allows as to the mode and timing of payment. It is not necessary that the price be paid in advance nor that it be paid at the time of the delivery. The parties can agree on a payment schedule convenient to both and the payment can also be made in installments.

As with the *bay' al-salam*, the *istisna'* contract is one in which an asset is bought or sold before it comes into existence. However, it differs from the *bay' al-salam* in that (i) it requires the underlying asset to be manufactured or constructed; (ii) there is no requirement to pay the full price at the time of the contract; (iii) it can be cancelled before the manufacturer undertakes manufacturing; and (iv) it provides flexibility in the time of delivery.

Like *ijarah*, *istisna'* also has great potential for application in the area of project finance in different sectors and industries. *Istisna'* have been applied successfully in aircraft manufacturing, locomotive and ship-building industries, and the manufacturing of heavy-duty machinery. The *istisna'* contract

is also suitable for use in the construction industry for building infrastructure such as roads, dams, housing, hospitals, and schools.

## FINANCING CONTRACTS

At one end of the risk continuum, the system offers low-risk asset-based securities, while at the other extreme it promotes risky equity financing, including venture capital and private equity. In between, there are other collateralized securities originating from the *ijarah* or *istisna'* contracts attached to real assets which can cater to the needs of investors looking for short- to medium-term maturity.

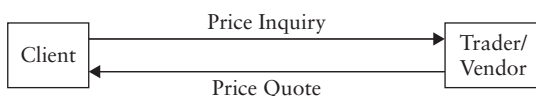
### **Murabahah (cost-plus sales)**

The *murabahah* is one of the most popular contracts of sale used for purchasing commodities and other products on credit. The concept is that a financier purchases a product—a commodity, raw material, etcetera—on behalf of an entrepreneur who does not have the capital to do so. The financier and the entrepreneur agree on a profit margin, often referred to as “mark-up,” which is added to the cost of the product. The payment is delayed for a specified period of time, during which the entrepreneur produces the final product and sells it in the market. To be a valid contract, *Shari'ah* requires that a *murabahah* should be the result of an original sale and should not be used as a means of financing any existing inventory. In addition, the financier must take ownership of the item on sale.

The *murabahah* was originally a sales transaction in which a trader purchased a product required by an end-user and sold it to the end-user at a price that was calculated using an agreed profit margin over the costs incurred by the trader. With the emergence of financial intermediaries such as banks, the trader's role as financier has been superseded.

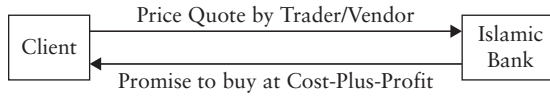
**The mechanics of *murabahah*** A typical *murabahah* transaction as practiced today involves three players—the financier or the Islamic bank, the vendor or the original seller of the product, and the user of the product who requires the bank to purchase and finance on their behalf. The transaction is explained in detail in the following steps:

**Step 1:** The potential purchaser asks the vendor to quote a price for the goods required.

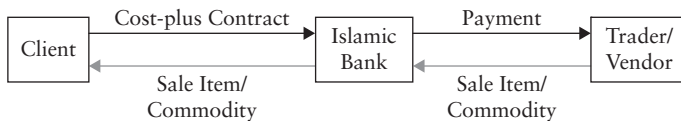


**Step 2:** With this quotation, the purchaser contacts the bank, promising to buy the goods from the bank if the bank buys the same from the vendor

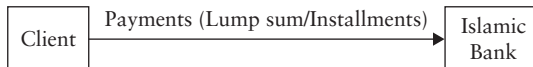
and resells them to the client at the quoted cost plus a profit to be agreed upon mutually. At this stage, the bank would consider entering into a *murabahah* contract, and would set the conditions and guarantees for the acceptance.



**Step 3:** The bank purchases the product from the vendor by making payment. In order to avoid getting involved with accepting the delivery and making arrangements to store the product, often banks appoint the client as their agent to accept the delivery on their (the bank's) behalf.<sup>3</sup> Since the bank is still the owner of the product, a *murabahah* contract is drawn up between the client and the bank indicating the mark-up to be charged and other relevant details. The contract is finalized by agreeing on the mode of payment; that is, a lump sum or through installments. In addition to the contract, the bank also accepts the goods or other assets as collateral against the credit risk or the risk of default in payment by the client.



**Step 4:** The client makes the payment to the bank at the designated time and in the agreed manner. This payment includes the cost of the product to the bank plus a profit margin for the bank.



### Features and Conditions

(i) *Murabahah* must be based on a sale and cannot be used for a purpose other than purchasing a product. For a sale transaction to be valid under the *Shari'ah*, the sale item is really purchased by the financier, who takes ownership and possession of it.

(ii) In the event of default by the end-user, the financier only has recourse to the items financed and no further mark-up or penalty may be applied to the outstanding liability. As opposed to conventional loans, there can be no accrual of interest. It is common practice among Islamic banks to consider the non-payment of two consecutive installments as default, at which stage the bank is entitled to declare that all the other installments are due immediately. In some cases, *Shari'ah* scholars allow the financier to recover additional amounts to offset any loss or damage arising from the default.

(iii) The financier is allowed to ask for security to protect itself against any non-payment in the future. Often an asset other than the item being

financed through the *murabahah* is taken as security, but when no such asset is available, the financier takes the item itself as security. This may require additional claims by the financier on the item financed, such as naming the financier as a beneficiary in the insurance policy.

(iv) The mark-up rate charged by the financier is influenced by the type of product, the type of security and collateral, the creditworthiness of the client, and the length of time for which the financing takes place.

(v) Another distinct feature is that the resulting financial claim resembles conventional debt security characterized by a predetermined payoff. The difference is that Islamic instruments are clearly and closely linked to, and collateralized against, a real asset and are consummated by a transactional contract. As a result, a financial claim is created against a real asset with a short-term maturity and relatively low risk.

Although *murabahah* financing is allowed by the *Shari'ah* and is very popular with Islamic banks, there are some misconceptions about the instrument among those who do not fully understand the contract. The misunderstanding stems from the question of the difference between the mark-up and interest, since *murabahah* results in a financial claim like a zero-coupon bond with a fixed rate of interest. This misunderstanding is further compounded when an outsider observes a close relationship between the mark-up and the prevailing interest rate in the market, such as LIBOR. Researchers have addressed both of these questions.

In distinguishing *murabahah* from a loan, it is pointed out that in the former no money is loaned but a specific asset is purchased for the client to ensure that the financing is linked to an asset. In addition, whereas in lending money as a loan the financier is exposed to credit risk only, in a *murabahah*, the financier is first exposed to the price risk when the product is acquired for the client because the client retains an option to decline to take delivery of the product.<sup>4</sup> Therefore, it is argued that by engaging in buying and selling the product, the bank is exposing itself to risks other than simple credit risk, as well as promoting trading (exchange) of a real asset; hence, a *murabahah* transaction is different from a simple loan.

The confusion in equating *murabahah* with a loan is not a new one. As mentioned earlier, Arab traders posed the same question during the time of the Prophet (pbuh). The legal difference between a *murabahah* contract and an interest-based loan is clear: the former is a sales contract in which the price is increased for deferment of payment; the latter is an increase in the amount of a debt for deferment. The first is permitted, but the second is not.

The practice of using an interest-rate index to determine the mark-up rate has been the source of confusion and the focus of much criticism. Islamic banks often argue that the mark-up rate is the function of an interest-rate index because there is no Islamic benchmark that can provide an indication of the prevailing rate of return in the economy. This necessitates the creation of an index to track the expected cost of capital and the rate of return which can be used to price financial instruments.



**Bai' bithamin ajil (BBA):** In Malaysia and other Southeast Asian countries, a form of *murabahah* in which payment is made in installments sometime after the delivery of goods is referred to as *bai' bithamin ajil*. It is similar to a *murabahah* in that the financier undertakes to buy the asset required for resale to the client at a higher price, as agreed to by the parties involved. However, it differs in that it is used for long-term financing and the seller is not required to disclose the profit margin that is included in the selling price.

**Tawarruq:** Also known as “reverse *mudarahah*,” the *tawarruq* is a mechanism for borrowing cash by undertaking two separate transactions. In a typical *tawarruq* transaction, a person buys a commodity or goods from the seller on credit, on the understanding that the price will be paid, either in installments or in full, in the future. Once the commodity is purchased, it is immediately sold to a third party at a spot price lower than the purchase price. In this way, a loophole is created to borrow money by using two legitimate *Shari'ah* transactions. In financial terms, this mechanism amounts to the creation of a zero-coupon loan, where the cost of borrowing money (interest rate) is at the same rate which the original seller might be charging to defer the payment, excluding any transaction costs.

The practice of *tawarruq* is a recent development in the Middle East market, especially in Saudi Arabia, but it has not received a wide acceptance and there is considerable resistance to the practice. Technically, from the *Shari'ah*'s point of view, the practice is legitimate, but several scholars have condemned its widespread practice on the grounds that it opens the door to borrowing money on the basis of *riba* and without creating any real economic activity, as the same commodity or product might be sold to several borrowers. The practice is disliked by scholars, particularly where the borrower of the money sells the commodity or goods back to the original seller.

### ***Musharakah* (partnership)**

The partnership is a pre-Islamic contract that was widely accepted and promoted by the Prophet (pbuh). The *musharakah*—a hybrid of the *shirakah* (partnership) and the *mudarahah*—is a combination of investment and management.<sup>5</sup> In the absence of debt security, the *Shari'ah* promotes the *musharakah* form of financing and is fairly comprehensive in defining different types of partnerships, in identifying rights and obligations of the partners, and in stipulating the rules governing the sharing of profits and losses.

A *musharakah* or *shirakah* can be defined as a form of partnership where two or more people combine either their capital or labor to share the profits and losses, and where they have similar rights and liabilities. A special case of partnership of capital and labor is known as a *mudarahah*, which is the cornerstone of Islamic financial intermediation. In general, the term *musharakah* is commonly used to refer to partnerships, but there are further sub-classifications of partnerships with respect to the levels of the partners' authority and obligations, and the type of their contributions for example,

management skills or goodwill, and so on. For the sake of our discussion, we will refer to a *musharakah* as a partnership based on capital contribution.

### *Features and Conditions*

- The partnership agreement need not necessarily be formal and written; it can be informal and oral.
- Every partner is an agent of and for the other, as all the partners benefit from the *musharakah* business.
- Every partner enjoys equal rights in all respects, in the absence of any condition to the contrary.
- Every partner has a right to participate actively in the affairs of *musharakah* if they so wish. However, in case of formal legal entities such as limited companies and cooperative societies, partners delegate their rights to participate in the management to professional managers.
- The ratio of each partner's share in the profits is predetermined as a proportion or percentage; no fixed amount can be predetermined.
- There is unanimity among *Shari'ah* scholars that any loss is to be borne by the partners according to their capital contribution. The *Shari'ah* is very clear that if a party has not invested any capital in the partnership, they are not liable for the loss. This implies that any capital investment is subject to the risk of loss of capital, but any investment of labor or time is limited to the loss of the time invested and the loss of capital is not required to be shared by such a partner.
- The *Shari'ah* recognizes the limited liability of shareholders in a *musharakah*-based legal entity, such as a joint stock company or a corporation. Shareholders cannot be held liable for more than their share of capital invested.
- Whereas a partner can withdraw from a partnership after discharging their liabilities as agreed by the partners, a shareholder in a company cannot withdraw from the partnership. They can exit the partnership by selling their share in the market.
- A loss incurred during one period can be carried forward and offset against the profits of the next period, if any. However, until the total loss has been written off, any distribution of "profit" will be considered as an advance to the partners. In order to avoid such a situation, the practice of building reserves from profits against future losses is recommended.

In modern times, Islamic banks have developed what is known as a "consecutive partnership," which considers depositors during a full financial year as partners in the proceeds of that financial year, regardless of the full usage of their funds during this period. Similarly, adjustments are made in the profits for proceeds accrued, but not realized, during a financial period. This was necessary to overcome the accounting problems with the determination of the profit and loss of each depositor based on the deposit

period and also to prevent withdrawals by a depositor from investments funded by the depositor.

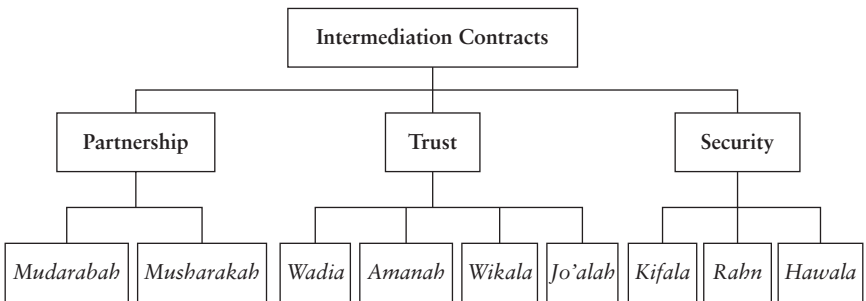
Another form of *musharakah* is being used to provide housing mortgages by forming a contract between the financier and the customer, who own the real estate jointly. This contract is commonly known as a *musharakah mutanaqisah* or “diminishing partnership.” Unlike an *ijarah*-based mortgage, where the ownership of the house remains with the lessor/owner for the entire lease period, ownership in a diminishing partnership is explicitly shared between the customer and the financier. As the name indicates, the ownership of the financier diminishes over time as the customer purchases a share with each monthly payment. The customer’s periodic payments can be divided into two parts; one paying a proportionate rental to the financier based on the financier’s share of the property, and the other as an equity contribution to buy out the financier’s share of the equity. Gradually, over time, the customer is able to buy out the financier’s share and thus acquires complete ownership of the property.

**INTERMEDIATION CONTRACTS**

As mentioned earlier, the *Shari’ah* makes provision for a set of contracts, known as “intermediation contracts,” which provide a wide range of typical intermediation services such as asset transformation, payment system, custodial services, and risk management. Intermediation contracts can be further sub-classified into three groups, as shown in Figure 4.3.

**Partnership**

The first group of intermediation contracts is the most significant; it deals with intermediation through forming a partnership of capital and entrepreneurial skills. The second group, based on the concept of trust, deals with the placing of assets with intermediaries on the basis of trust for the sake of protection or security. The third group facilitates explicit and implicit



**FIGURE 4.3** Intermediation contracts

guarantees of financial performance between economic agents. These contracts play a critical role in that they provide stability and mitigate risk in the financial system.

Intermediation contracts based on the principles of partnership include both *mudarabah* (a trustee finance contract) and *musharakah* (equity partnership). In a *mudarabah* contract, an economic agent with capital (*rabbal-mal*) can develop a partnership with another agent (*mudarib*) with the skills to form a partnership, with the agreement being to share the profits. Although losses are borne by the capital owner only, the *mudarib* may be liable for any loss arising from misconduct or negligence on his part.

Both *mudarabah* and *musharakah* are cornerstones of financial intermediation for mobilizing resources, and are akin to an agent who develops expertise and knowledge of different markets and acts as an intermediary to screen and monitor investment opportunities for the deployment of funds placed with it. In this respect, *mudarabah* and *musharakah* contracts have existed as instruments of financial intermediation from the early periods of Islam. Both were able to mobilize the entire reservoir of the monetary resources of the medieval Islamic world for financing agriculture, crafts, manufacturing and long-distance trade. These instruments were used not only by Muslims but were also acceptable and practiced by Jews and Christians to the extent that interest-bearing loans and other usurious practices were not in common use.

There is evidence that these two contracts spread rapidly throughout the Middle East and then to the other corners of the globe wherever Muslim traders were active in business and trade. In the Arabian Peninsula, the second caliph is known to have invested the money of orphans with merchants who traded between Medina and Iraq. Similarly, as early as the seventh century AD, tax revenues from Iraq were sent across the desert to Medina (Saudi Arabia) on the basis of *mudarabah*. It has been documented, too, that the trade between Egypt and Tunisia took place on this basis. The practice of *musharakah* is known to have existed in the north–south trade between Egypt and Syria as well as between Egypt and Saudi Arabia, during the eleventh century.

With the encouragement and blessing of early Muslim jurists, partnership-based intermediation contracts were promoted, which led to the evolution of *mudarabah* and *musharakah* contracts as standardized, well-documented and well-established financial instruments. However, around the eleventh and twelfth centuries, further advancements in these contracts slowed, with the result that further innovation of financial instruments became limited. However, the concept was expanded further in Europe, where the business community constantly expanded its partnerships and invented larger and larger enterprises. The increasing size of European partnerships meant that the savings of the small investors were effectively channeled into large investment projects. The concept of the joint-stock company or the modern-day corporation grew out of the concept of partnership, but on a larger scale.

Whereas *mudarabah* and *musharakah* contracts are critical in credit and capital creation, other contracts such as *wikala*, *jo'alah* and *rahn* also play an important role in providing vital economic services equivalent to those that a conventional financial intermediary may offer.

**Mudarabah** In a *mudarabah* contract, an economic agent with capital develops a partnership with another economic agent who has expertise in deploying capital into real economic activities, with an agreement to share the profits. The earliest Islamic business partnerships can be traced back to the Prophet (pbuh) himself, who acted as an agent (*mudarib*) for his wife when he undertook several trade expeditions on her behalf. *Mudarabah* partnerships performed an important economic function by combining the three most important factors of production—capital, labor, and entrepreneurship. Typically, the *mudarabah* contract involved an arrangement in which the capital-owner entrusted capital or merchandise to an agent (*mudarib*) to trade with it and then return to the investor the principal plus an agreed share of the profits. As a reward for his labor and entrepreneurship, the *mudarib* received the remaining share of the profit. Any loss resulting from the exigencies of travel or from an unsuccessful business venture was borne exclusively by the investor.

More formally, a *mudarabah* is a contract of partnership between the investor (principal) and the entrepreneur who acts as an agent to invest the money in a fashion deemed suitable by the agent. This contract is usually limited to a certain period of time, at the end of which the profits are shared as agreed. An example of *mudarabah* in modern times would be of a contract between an investor and an Islamic bank where the investor deposits funds with a bank that has developed a certain expertise in the financial markets and in identifying profitable projects and uses its management skills to invest those funds on the investor's behalf. After a certain period, both the bank and the investor share the profits in accordance with their predetermined profit-sharing ratios.

The *mudarabah* has the following distinct features:

**Control** Although *Shari'ah* scholars have differences of opinion about the restrictions in a *mudarabah* contract in regard to its activities, scope, and objectives, these differences do not have any significant impact on its function. In general, the investor designates the *mudarib* as an agent and therefore does not have any right to control, or participate in, the *mudarib*'s decisions as to the placement of funds. In other words, the investor does not have any management rights over the *mudarib*, who is free to select the projects in which to invest or the manner in which to invest. However, in some cases, the investor may impose some upfront restrictions on the agent to participate in a particular project or in a particular fashion. In such cases, the contract is known as "restrictive *mudarabah*." If the *mudarib* acts contrary to such conditions or restrictions, he is deemed to have acted beyond his

powers and, therefore, by virtue of the trust that was placed in him, to be liable for any resulting loss or damage.

**Profit/loss sharing** One of the most significant features of *mudarabah* is that while the profits are shared between the investor and the agent, any loss in the investment or business is borne solely by the capital-owner, unless such loss is caused by the misconduct or negligence of the *mudarib*. In cases where the agent acts in good faith and prudently, but still the investment results in a loss, the capital owner loses a portion of the capital, but the agent loses the time and effort deployed during the business venture. The capital-owner suffers a financial loss from the loss of capital, while the agent/entrepreneur does not make any financial gains and loses the potential reward for his skills. The *mudarib* is not a guarantor of the capital, except where there is misconduct or negligence on his part.

**Profit distribution** In the *mudarabah* agreement, the partners enjoy absolute freedom to determine the division of profits. The following are some of the rules applicable to the determination and distribution of profit and loss under a *mudarabah*:

- The most critical requirement is that the division of profits between the investor and *mudarib* must be in the form of proportions and ratios, rather than in absolute numbers.
- The profit-sharing formula itself must be made specific beforehand and must be clearly indicated in the agreement for profit distribution. Neither party can have preferential rights over the profits to the exclusion of the other.
- The profit distribution ratio may differ from that of capital contribution.
- The distribution of profits in a *mudarabah* can only take place after the capital-owner has retrieved his capital. Any interim or periodic distribution before the closing of the accounts is considered tentative and subject to final review and revision and has to be made good on any loss of capital. In other words, if any periodic return was paid based on expected profits or interim proceeds, it is to be treated as a partial return before the conclusion of the contract, when the final profit or loss will be determined after adjusting for any interim profits paid.

**Multiple tiers** Early *Shari'ah* scholars played an important role in the development of complex intermediation structures by granting the necessary freedom to the *mudarib* to form other partnerships with third parties. On the one hand, this allowed the *mudarib* to expand the partnership to create a large pool of capital providers as passive partners and, on the other, it allowed a *mudarib* to engage entrepreneurs on the basis of *mudarabah* to invest the capital entrusted to the *mudarib*. This flexible structure of different tiers has become the basis of modern Islamic banks.

**Credit risk and defaults** Since there may not be any tangible assets that can be used as collateral against potential losses, managing the credit risk and defaults often becomes an issue. To minimize such risk, the capital-owner or investor should perform due diligence in respect of the past performance and reputation of the *mudarib*. By the same token, the *mudarib* entrusted with investing funds should perform adequate screening and monitoring of potential projects worthy of good investment opportunities. In cases where an Islamic bank is acting as the *mudarib*, it may ask for a guarantee, pledge or collateral of a property from the business.

## Trust

**Wakala** The contract of *wakala* entails designating a person or legal entity to act on one's behalf or as one's representative. It has been a common practice to appoint an agent (*wakil*) to facilitate trade operations. A *wakala* contract gives power of attorney or an agency assignment to a financial intermediary to perform a certain task. On the surface, there does not appear to be much difference between a *mudarabah* and a *wakala* contract, since both are principal-agent contracts. However, under a *mudarabah*, the *mudarib* has full control and freedom to utilize the funds entrusted. In the case of a *wakala*, the *wakil* acts only as a representative to execute a particular task according to the instructions given.

**Amanah, Ariya and Wadia** *Amanah* (trust), *ariya* (gratuitous lending) and *wadia* (deposits) contracts are all concerned with placing assets in trust. These contracts are utilized in facilitating a custodial relationship between investors and the financial institutions.

*Wadia* arises when a person keeps his/her property with another person for safe keeping and allows the trustee to use it without the intention of receiving any return from it. The *wadia* assets delivered for safe keeping are a trust in the hands of the person who accepts them. Liability arising out of the *wadia* contract depends on the nature of the agreement. For example, if the trustee does not charge a fee for the safe keeping services, the trustee is not liable for the losses other than those arising from his/her negligence. However, if a fee is involved as part of the contract, then the trustee is liable to compensate in the event of loss. The trustee can, with the owner's prior permission, let the asset on hire, lend it for use, pledge the asset or use it him/herself, but must return it on demand.

The term "*amanah*" (trust deposit) is a broad term where one party is entrusted with the custody or safekeeping of someone else's property. For example, when an employer hands over a property to an employee, it comes under the contract of trust. However, in the context of intermediation, *amanah* refers to a contract where a party deposits its assets with another for the sole purpose of safekeeping. Unlike *wadia*, where the keeper of the asset is allowed to use the asset, an *amanah* deposit is purely for safe keeping and the keeper cannot use the asset. Demand deposits of an Islamic bank are

offered through *amanah* contracts, under which a person entrusted with the safe keeping of property who is found to be negligent or guilty of not taking proper care of the property is held liable for any losses.

*Ariya*, or lending for gratuitous use, is a contract where the lending of an asset takes place between a lender and the borrower, with the agreement that the former will not charge anything for the use of the asset he lent out. In other words, the borrower is entitled to enjoy the benefits yielded by the asset borrowed, without giving any payment or rent to the lender. The borrower is responsible for the maintenance and upkeep of the asset to the best of their capability. The borrower is to return the item immediately on demand by the lender. The lender may impose restrictions as to time, place and nature of use. The lender can discontinue the contract and withdraw the loan at any time.

**Jo'alah** The contract of *jo'alah* deals with offering a service for a predetermined fee or commission. One party undertakes to pay a specified amount of money to another as a fee for rendering a service stipulated in the contract. *Jo'alah* allows contracting on an object not certain to exist or come under a party's control. It can be utilized to introduce innovative financing structures. In this respect, the scope of the *jo'alah* contract is wide enough to open up several fee-earning opportunities and can be utilized to offer advisory, asset-management, consulting and professional services, fund placements and trust services often offered by investment banks in the conventional system. In addition, by using this contract, a financial intermediary can offer custodial services for customers in the securities market as well, where securities change hands in a relatively short period of time, thus performing another important task of a modern financial intermediary.

## Security

**Rahn** A financial institution reduces its credit risk of non-payment by the borrower by securing a financial obligation either through personal surety or through a pledge. In other words, the lender takes an asset as collateral against a financial liability to make sure that the borrower will repay the debt. The contract of *rahn* (or pledge) is to make a property a security provided by the borrower against a loan, so that in case of the borrower's inability to make the payment, the liability may be recovered from the value of the pledged property. The *rahn* has the following features:

- Only assets with a sale value can be offered in pledge.
- Two different creditors may take a common pledge from a single debtor, in which case the pledge will secure the whole of the two debts.
- Acceptance of the pledge does not cancel the demand for repayment of the debt by the creditor.
- If at the time for repaying the debt the borrower refuses to make payment, the lender may approach the court to force the borrower to sell the pledged



asset in order to recover the debt. Where the borrower refuses to do so, the court has the authority to sell the pledged asset to repay the debt.

**Kifala** The contract of *kifala* (“suretyship”) refers to an obligation in addition to an existing obligation in respect of a demand for something. This may relate to an individual, an act or a financial obligation. A *kifala* for an act or the performance of an act entails the timely delivery/fulfillment of the obligation or timely action in respect of the task contracted by the principal. In the case of a financial obligation, it refers to an obligation to be met in the event of the principal debtor’s inability to honor the obligation. In financial transactions, under the contract of *kifala*, a third party becomes a surety for the payment of a debt or obligation, if it is not paid or fulfilled by the person originally liable. It is similar to a pledge given to a creditor that the debtor will pay the debt, fine or any other liability. In this respect, the *kifala* can become the basis of a more sophisticated vehicle for a financial intermediary to undertake financial and performance guarantees and for the underwriting of financial claims, which are an integral part of modern banking and capital markets.

The following are some of the features of *kifala*:

- It does not release the principal debtor from liability since it is an obligation in addition to the existing obligation.
- More than one *kifala* for a single obligation is acceptable.
- Persons jointly indebted may provide surety for each other, in which case both of them are jointly liable for the whole debt.
- If a delay is granted to the principal debtor for the payment of his debt, it implies that a delay is also granted to the *kifala*.
- The discharge of the *kifala* does not necessarily discharge the liability of the principal debtor.

**Hawala** *Hawala* entails transferring a debt or obligation from one debtor to another, releasing the original debtor from that debt or obligation. This is different from the *kifala*, where the principal debtor is not released from the obligation.

The historical background to Islamic financial instruments can be found in Appendix B.

## APPENDIX **B**

# Islamic Instruments: Historical Background

**T**he mercantile communities of the Middle East followed a sophisticated tradition of trade and business partnerships that can be traced back to the pre-Islamic period. With the introduction of Islam, the examination of common business practices began with a view to identifying those practices which were in direct conflict with its teachings. This process continues to this day. However, one of the major contributions of Islam was to codify, systematize, and formalize traditional trade and business practices into a formal legal system of standardized contracts, leading to a mercantile law in complete harmony with Islam.

As Islam spread out of Arabia to other geographical regions, new situations, business practices, cultures and customs were put to the same test of conformity to the tenets of Islam. Islamic practices and contracts became well-known from one corner of the globe to another, as scholars have noted:

*Through their trade and commerce in the Middle Ages, Muslims spread over the continents of Asia and Africa and into Europe, bringing with them their religion and their cultures. From the earliest days of the expansion of Islam to the present day, Muslim businesses have been models of success and integrity. Islamic business in history is an exotic and dynamic panorama that ranges from gem merchants in Ceylon, to caravan traders in Mali, to dealers of saffron in Muslim Spain, to sellers of aromatic oils in the deserts of Arabia, to colorful cotton markets in Turkey, to spice markets in India, to the hardwood merchants of Malaysia, to the plantations and industry of Indonesia, to carpet makers in Kashmir, to the great merchant houses of the Levant, to the oil of the Arabian Peninsula, North Africa, and Brunei. The business practices and ethics in all of these places, and from the moment that Muslims arrived there, are derived from the same source.<sup>6</sup>*

During the period referred to as “the age of the commercial revolution” (Lopez 1976), trade flowed freely across the known world, supported by the risk-sharing methods of finance developed in the Muslim countries consistent with the *Shari’ah*. Information regarding the basic features of these methods spread through Europe, Egypt, India, and North Africa. These new financial techniques were also transmitted by Muslim merchants to Eurasia, Russia and China, as well as to East Asia.<sup>7</sup>

Among these were the *commenda* and *maona*—two popular financing instruments in the Europe of the Middle Ages—which were undoubtedly based on the *musharakah* and *mudarabah* from the Islamic world.<sup>8</sup> These institutions, along with financial instruments such as *hawala* and *suftaja*, were transmitted to Europe and to other regions by Jewish scholars and merchants throughout the Jewish Diaspora and via Spain through trade and scholastic borrowing from Islamic sources.

Thanks to the latest research conducted on the Geniza archives in Cairo, our understanding of historical Biblical writings and translations, ancient Jewish liturgies, communal records and relations between Jews and Arabs in medieval Islamic society has increased enormously.<sup>9</sup>

From these records and Islamic *fiqh* sources, it is clear that there is what has been called a “remarkable symmetry between the legal formulations of the late-eighth century and the documented commercial practices of the eleventh and twelfth century Geniza merchants.”<sup>10</sup>

The Geniza records provide little evidence of lending money for interest, which was shunned religiously and of limited significance economically. However, trade in the Middle Ages was both extensive and intensive, financed by risk-sharing partnerships in industrial, commercial and public administration projects.

The practice of *mudarabah* is well-documented in the westward trade between Egypt and Tunisia. The same sources make it clear, too, that *musharakah* partnerships were being practiced in the north–south trade between Egypt and Syria as well as between Egypt and Jeddah during the eleventh century.<sup>11</sup>

Similarly, 32 *mudarabah* contracts from the seventeenth century were discovered in the Turkish city of Bursa and were clearly the most important type of business partnership being practiced there at that time. Interestingly, these partnerships were, for all practical purposes, identical with the classical ones observed in the Geniza archives. Lively trade exchanges also took place between the Arabian Peninsula and India. Goitein, for instance, has found 315 documents in the Geniza archives dealing specifically with trade in the Indian Ocean. Islamic partnerships were observed even further East, in Indonesia, at the other end of the Indian Ocean.<sup>12</sup>

Before the beginning of the twentieth century, most economic historians of the Middle Ages ignored the importance of trade and financial relations between Europe and the rest of the world, which were crucial to the economic development of the West before the fifteenth century. Abu-Lughod (1994) contends that this was the result of the belief among Eurocentric

scholars that globalized trade became relevant only after the “rise of the West” in the late fifteenth century. According to Abu-Lughod, an advanced globalized system of trade “already existed by the second half of the thirteenth century, one that included almost all regions (only the “New World” was missing). However, it was a world-system that Europe had only recently joined and in which it played only a peripheral role.” She maps growing global trade flows between 737 and 1478 AD, demonstrating that trade flows first centered in Mesopotamia and spread rapidly over the next eight centuries throughout the then-known world to become global.

There is ample evidence that Islamic modes of financing and intermediation were widely used in several regions of the world. What is even more important to note is that the available evidence is scattered not only across geographical space but also across time, thereby demonstrating to us the universality as well as the tremendous resilience of these institutions. It is important to note that the charging or payment of interest in business transactions was avoided as far as possible and, on the other hand, equity or partnership-based financing was encouraged. That shows how Islamic partnerships dominated the business world for centuries and also that the concept of interest found very little application in day-to-day transactions.

## ENDNOTES

1. From a legal perspective, a contract in Islam can be either unilateral or bilateral. Unilateral contracts are usually of a gratuitous nature and may not require the consent of the recipient. Such contracts comprise gifts (*hadiah*, *hibah*) or writing-off a debt (*ibra*) or endowment (*waqf*). Bilateral contracts, on the other hand, are more formal contracts and require the informed consent of both parties. They are subject to strict guidelines and rules when it comes to their documentation, rights and obligations. What is normally accepted or tolerated in unilateral contracts would not necessarily be accepted or tolerated in bilateral contracts. All commercial contracts are bilateral contracts and are therefore regulated by well-established legal rulings.
2. The general practice of Islamic banks is to wait for two consecutive defaults before taking any action.
3. In Sudan, Islamic banks do not authorize their clients to accept delivery of the product being financed. It is common practice among banks to take delivery and then at a later stage offer to sell the same to the client, who has the right to accept or reject the offer.
4. It is common practice among Islamic banks to take a promise from the client before purchasing the product that the client will purchase the product from the bank.
5. In the early books of *fiqh*, the partnership business was discussed mainly under the heading of *shirakah*. However, contemporary scholars have preferred to use the term *susharaka* to represent a broader concept combining features of *shirakah* and *mudarabah*. Therefore, in a *musharakah*, a *musharik* also provides capital in addition to the management skills. For further details, see Ayoub (2002).
6. See De Lorenzo and Talah (2002).

7. Abu-Lughod (1989).
8. See Udovitch (1970a), (1970b), (1967a), (1967b).
9. Goitein (1964) refers to Geniza archives as “a treasure of manuscripts written mainly during the Fatimid and Ayyubid periods and originally preserved in a synagogue in Old Cairo.” Further, he indicates that “Geniza, as may be remarked in passing, is derived from the same Persian word as Arabic ‘*janazah*,’ burial, and has almost the same meaning. It is a place where discarded writings were buried so that the name of God, which might have been written on them, might not be discarded. Thus, Geniza is the opposite of an orderly archive.” He further informs us that “the documents discussed in this paper, albeit mostly written in Hebrew characters, are in Arabic language.”
10. Udovitch (1970b).
11. For further details, see Goitein (1964), Gerber (1981) and Firestone (1975).
12. Ibid.

## CHAPTER 5

# Risk Sharing as an Alternative to Debt

**I**slam has long endorsed risk sharing as the preferred organizational structure for all economic activities, prohibiting interest-based contracts of any kind. Indeed, as we have seen, it requires mandatory risk sharing with the poor, the deprived and the handicapped based on its principles of property rights.

The notion of risk has many dimensions. In general terms, it entails the possible occurrence of an event—accident, fire, sickness, perhaps—that leads to a loss. Economic agents who face such common risks try to transfer and reduce their risk exposure through insurance. Automobile drivers can transfer their accident risk by buying car insurance. Industrial plants are exposed to various risks such as fire and theft; industrialists transfer these risks through insurance. Labor faces the risk of unemployment; labor transfers this risk through unemployment insurance. Retirees face the risk of losing their income; they transfer the risk through social security or pension plans.

Much has been written about risk and the sources of risk but the emphasis has, for the most part, been on risk transfer rather than risk sharing. This chapter discusses the Islamic perspective on risk and how it can be mitigated by sharing. Further, it addresses the broader implications and stability of a financial system based on the sharing of risk.

### UNCERTAINTY AND RISK

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Uncertainty is a fact of human existence and stems from the fact that the future is unknown and therefore unpredictable. Uncertainty, if severe enough, can lead to anxiety and inaction. For each of us, a lack of certainty about the future is exacerbated by ignorance of how others behave in response to uncertainty. Yet individuals have to make decisions and take actions that affect their own lives as well as those of others. Decision-making is one of the most fundamental of human capabilities and is inexorably bound

up with uncertainty. Facing an unknown and generally unknowable future, individuals make subjective decisions by forming expectations about the payoffs attached to alternative courses of action. Alternatively, the person can use known probability techniques to form an expectation of returns from a particular action. Either way, the expected outcomes will form an expression in terms of probability of occurrence of the consequences of an action.

In other words, uncertainty is converted into risk. Risk, therefore, is a consequence of choice under uncertainty. As one commentator put it:

*. . . even in the most orderly societies the future is by no means certain. Even if an individual or organization has defined goals they must reflect their attitude toward risk. In some cases risk may be evaluated statistically . . . [W]hen a population is large enough, some odds can be calculated with fair accuracy, as is exemplified by some calculations in the life insurance area. In general, however, many of the aspects of uncertainty involve low probability or infrequent events. (Shubik 1978: 124)*

This makes decisions difficult and actions risky. Risk exists when more than one outcome is possible. It is uncertainty about the future that makes human life full of risk.

Risk can arise because the decision-maker has little or no information regarding which state of affairs will prevail in the future, or does not or cannot consider all possible states that can prevail in the future. There is so much missing information that it is impossible to form expectations about payoffs to various courses of action. This situation is referred to as “ambiguity,” which, if severe enough, can lead to reluctance or even paralysis in making decisions. One strategy for dealing with this “risk aversion” is to exercise patience (a strategy commended many times in the *Qur’an*) and postpone making decisions until the passage of time makes additional “missing” information available.

In fact, the *Qur’an* makes it clear that this temporary existence is a crucible of constant testing, trials and tribulations from which not even believers are spared.<sup>1</sup>

To every test, trial and tribulation in their lives, humans respond and in their actions they demonstrate the measure of their self-awareness and the degree to which they are conscious of Allah (*swt*). If their actions are in compliance with the rules of behavior prescribed by the Supreme Creator as set down in the *Qur’an*, then the trial becomes an occasion for self-development and strengthened awareness of Allah (*swt*). Even then, uncertainty remains. No-one can be fully certain of the total payoff to life within the birth-to-eternity horizon. Muslims are recommended not to ever assume that they are absolutely certain of the consequences of their action. They are to live in a state of mind and heart suspended between fear (*khawf*) of the consequences of their actions and thoughts, and hope (*raja*) in the mercy

of the Creator. All actions are risky because the full spectrum of future consequences of action is known to no one but Allah (*swt*).

## ISLAM'S PERSPECTIVE ON RISK SHARING

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It follows from the above discussion that it would be difficult to imagine the idea of testing without uncertainty and risk. Statistician David Bartholemu (2008: 230) asserts that: "It could be plausibly argued that risk is a necessary ingredient for full human development. It provides the richness and diversity of experience necessary to develop our skills and personalities." He speculates that: "The development of human freedom requires that there be sufficient space for that freedom to be exercised. Chance seems to provide just the flexibility required and therefore to be a precondition of free will." (2008: 200) Further, he suggests (pp. 239–40) that:

*[W]e value our free will above almost everything; our human dignity depends upon it and it is that which sets us apart from the rest of the creation. But if we are all individuals free, then so is everyone else, and that means the risks created by their behavior, foolish or otherwise, are unavoidable. To forgo risk is to forgo freedom; risk is the price we pay for freedom.*

Muslims believe that life and freedom are gifts of the Supreme Creator, and uncertainty and risk are there to test and try man to facilitate his growth and development. People are not left unaided to face the uncertainty of life and suffer its consequences. Prophets and messengers have brought guidance on how best to make decisions and take actions to mitigate the risks of this life and to improve the chances of a felicitous everlasting life. Islam, in particular, has provided the ways and means by which the uncertainties of life can be mitigated.

First, it has provided rules of behavior and a taxonomy of decisions—actions and their commensurate payoffs. Complying with these rules reduces uncertainty. Clearly, individuals exercise their freedom in choosing to comply or not. That rules of behavior and compliance with them reduce uncertainty is an important insight of the new institutional economics. Rules reduce the burden on cognitive capacity, particularly in the decision-making process under uncertainty. Rules also promote cooperation and coordination (Mirakhor 2009). Second, Islam has provided ways and means by which those who are able mitigate uncertainty by sharing the risks they face by engaging in economic activities through exchange with others. Sharing allows risk to be spread and thus lowered for individual participants. However, if poverty prevents a person from using any of the means of risk sharing, Islam requires the rich to share the risks of the poor by redeeming their rights derived from the Islamic principles of property rights.

Individuals face two types of risks. The first derives from the exposure of the economy to uncertainty and risk arising from external and internal



economic circumstances and its vulnerability to shocks. How well the economy is able to absorb shocks depends on its resilience which will, in turn, depend on the institutional and policy infrastructures of the particular society. How flexibly these respond to shocks will determine how much these risks will affect individual lives. The second type of risk that individuals face relates to the circumstances of their personal lives. These include risks of injury, illness, accident, bankruptcy or even changes of taste and preference. This kind of risk is referred to as idiosyncratic risk. When idiosyncratic risks materialize, the resultant shock to an individual's income can play havoc with their livelihood. Engaging in risk sharing can mitigate idiosyncratic risk and weaken the correlation between income and consumption such that should these risks materialize the individual's consumption and livelihood do not suffer correspondingly.

As we shall see, instruments of Islamic finance enable risk sharing and diversification through which individuals can mitigate their idiosyncratic risks. Levies—mandated or otherwise—such as *zakah*, *sadaqat* and *qard-ul-hassan*, enable the idiosyncratic risks of the poor to be shared by the rich, thus helping to reduce the poor's income–consumption correlation. In other words, the poor are not forced to rely entirely on their low level (or no) income to maintain a decent level of subsistence living for themselves and their families. It is possible that at some point even these levies can be instrumentalized to be included in the full-spectrum menu of Islamic financial instruments for risk sharing. In that event, Islamic finance would become a risk manager for society.

Such instruments will also ensure that innovators, entrepreneurs, small and medium-size firms have access to financial resources without having to take all risks on themselves or, alternatively, abandon productive projects altogether. There will be instruments of insurance that not only provide protection against health and accident risks but also insure against risks to livelihood and home values to protect people's long-term income and livelihood.

Such a full-spectrum Islamic finance can then truly be said to have “democratized finance” without transferring risks of any venture to a particular class or to the whole society. This would be in sharp contrast to the results of the recent global financial crisis in which the risks associated with dubious financial innovations were shifted away from financiers in such a way that while the gains were privatized, the pain was socialized (Sheng 2009).

## **RISK SHARING EMBEDDED IN ISLAMIC INSTRUMENTS**

With the exception of spot exchanges, all Islamic contractual forms involve time. From an economic point of view, time transactions involve a commitment to do something today in exchange for a promise of a commitment to do something in the future. All transactions involving time are subject to uncertainty, and uncertainty involves risk. Risk exists whenever more than one outcome is possible. Consider, for example, a contract in which a seller

commits to deliver a product in the future against payments today. There are a number of risks involved. There is a price risk for both sides of the exchange; the price may be higher or lower in the future. In that case the two sides have a shared risk once they enter into the contract agreement. If the price in the future is higher, the buyer will be better off and the price risk has been shed to the seller. The converse is true if the price is lower. There are other risks for the buyer, including the risks of non-delivery and quality. The seller also faces additional risks, including the risk that the price of raw materials may be higher in the future, as may transportation and delivery costs. This risk may also be lower. Again, these risks have been shared through the contract. The same argument applies to deferred payment contracts.

It may appear that spot exchanges or cash sales involve no risk. But price changes after the completion of a spot exchange are not entirely unknown. The two sides of a spot exchange share this risk. Moreover, from the time of the classical economists it has been known that specialization through comparative advantage provides the basis for gains from trade. But in specializing, a producer takes a risk of becoming dependent on other producers who specialize in producing what he needs. Again, through exchange, the two sides to a transaction share the risk of specialization. Additionally, there are pre-exchange risks of production and transportation that are shared through the exchange. It is clear that the contracts at the other end of the spectrum—*mudarabah* and *musharakah*—are risk-sharing transactions. Therefore, it can be inferred that by mandating *al-bai'*, Allah (*swt*) ordained risk sharing in all exchange activities.

A further observation that can be made is that it appears that the reason for the prohibition of *riba* is the fact that opportunities for risk sharing do not exist in such contracts. It may be argued that the creditor does take risk—the risk of default. But it is not risk taking per se that makes a transaction permissible. A gambler takes risk as well, but gambling is forbidden (*haram*.) Instead what seems to matter is opportunity for risk sharing. *Riba* is a contract of risk transfer. As Keynes emphasized in his writing, if interest rates did not exist, the financier would have to share in all the risks that the entrepreneur faces in producing, marketing and selling a product. But by decoupling his future gains, by loaning money today for more money in the future, from all activities of the entrepreneur, the financier transfers all risks to the entrepreneur.

It is clear that the intent behind prohibiting *riba* is to shift the focus to risk-sharing contracts of exchange. Ismail (1989), however, suggests that, based on the three interpretations considered, trade (*al-bay'*) and exchange (*al-tirajah*) are the same. These terms appear in a number of verses of the *Qur'an*, and in at least one verse (24:37) they appear together. Given the acknowledged beauty and eloquence of its rhetoric in conveying complex ideas, many scholars argue that it is unlikely that it would use two words in the same verse to refer to the same transaction contract. Indeed, major lexicons of the Arabic language reveal that the two phrases are not the same. These sources suggest, based on the *Qur'an* itself (2:16; 2:254; 9:111;

35: 29–30; and 61:10–13), that there is a major difference between contracts of exchange and trade. Trade contracts are always entered into with the expectation of making a profit (*ribh*). In a contract of exchange on the other hand, there is a possibility of gain but there is also the probability of a loss (*khisarah*).<sup>2</sup>

It can be inferred from the above discussion that there are two types of contracts involving time; (i) contracts over time (or on the spot) involving trade, in which there is the expectation of gain; and (ii) contracts over time involving exchange, in which there is an expectation of gain or loss. The latter must refer also to contracts of investment with uncertainty as to gain or loss. This, of course, does not mean that *mudarabah* and *musharakah* could not be used for longer-term trade in expectations of profits to be shared, and for long-term investment, as was the case for centuries in the Muslim world as well as in Europe in the Middle Ages.

Lopez (1976) suggests that there is a consensus among historians that the *mudarabah*—borrowed from Muslims and known as “*commenda*” in Western Europe—was of the highest importance as a means of financing the long-term trade and investment that led to economic change and growth in Europe. Therefore, it should be emphasized that *al-bay'* covers long-term investment contracts that allow the growth of employment and income and expansion of the economy. The focus of *al-tijarah* and all its financing instruments is the trade of commodities already produced. In effect, Islam meets the financing needs of trade as well as the requirements of resource allocation, investment, production, employment, income creation, and risk management.

Given the above, major economic implications follow. First, *al-bay'* is a contract for the exchange of property. This means that the parties to the exchange must have property rights over the subjects of the contract antecedent to the exchange. Second, exchange requires a place for the parties to complete their transactions; that is, a market. And, markets need rules of behavior to ensure an orderly and efficient operation. The contract of exchange requires trust among the parties that the terms and conditions of exchange will be enforced and there must be rules governing the distribution of proceeds after the terms of the contract have been performed. These are rules that govern the redemption of the rights of those who are not parties to the contract directly but who have acquired rights in the proceeds because, one way or another, they or their properties have contributed to the production of what is the subject of exchange.

## **FEATURES OF RISK-SHARING FINANCE**

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An important performance dimension of risk-sharing finance, in general, and of Islamic finance in particular, is whether it is more or less vulnerable than conventional finance (which relies heavily on debt finance) to principal-agent

and informational issues. Agency issues arise because of asymmetric information between agents (entrepreneurs) and principals (investors) and the possibility that the agent's utility maximization may not maximize the utility of the principal. The agency problem is normally addressed by incorporating incentive structures in contracts for the complete sharing of information and for the agent to behave in a way to maximize rewards for the principal. In addition, there are implications on risk transfer, cooperation among economic agents, and the stability of a financial system when risk sharing is widespread and encouraged across the system.

### **Reduced Information and Agency Problems**

Informational and agency problems have generally been discussed in the context of one risk/reward sharing instrument: equity. Stiglitz (1989), for example, suggests that there are two informational problems in such cases: (i) an adverse signaling effect, which leads good firms not to issue as much equity as they might wish to for fear that it may signal poor quality; and (ii) an adverse incentive effect, which suggests that equity finance weakens the incentive for the entrepreneurs (agents) to exert their maximum effort for the highest maximum joint returns for themselves and their shareholders (principals). This happens because once the project is financed, the entrepreneur knows that the net return will have to be shared with the financier (the principal) and, therefore, may not have a strong motivation to work as hard as when the return is not shared. There are also agency and informational problems in interest-rate based debt financing. Stiglitz points out that there is an inherent agency conflict in debt financing in that the entrepreneur (the agent) is interested in the high end of the risk–return distribution. The lender (the principal) on the other hand, interested in safety, focuses on the low end of the risk–return distribution, and therefore discourages risk taking. This, Stiglitz asserts (p.57), has “deleterious consequences for the economy.” He further suggests that “from a social point of view equity has a distinct advantage: because risks are shared between the entrepreneur and the capital provider, the firm will not cut back production as much as it would with debt financing if there is downturn in the economy.”

The agency problem has been generalized to bank lending. Banks, being highly leveraged institutions that borrow short (deposits) and lend long, are exposed to an asset–liability mismatch that creates potential for liquidity shocks and instability. Stiglitz (1989) suggests that to protect their financial resources, banks generally discourage risk taking. Additionally, their behavior toward risk often creates informational problems that lead to phenomena that can be classified as market failure, such as credit rationing. By contrast, Hellwig (1998: 335) argues that there is an oft-neglected informational problem in the lending behavior of banks, which he refers to as “negative incentive effects on the choice of risk inherent in the moral hazard of riskiness of the lending strategy of banks.” This risk materialized

dramatically in the run-up to the recent financial crisis (see Askari *et al.* 2010; Sheng 2009).

Given this background, the question is whether Islamic contracting (with risk sharing) is better suited to solving this contractual dilemma through its reliance on risk/reward sharing under conditions where interest-based debt financing is prohibited. In the presence of informational problems such as asymmetric information (where only one side of the contract, usually the agent, has information not available to the other parties) there is a transaction cost as well as the cost of monitoring the agent's activities and the project(s) to be taken into account. It could be plausibly argued that in Islamic contracts asymmetric information issues would be minimized. This assertion is supported by the strict rules governing contracts, exchange and trade enunciated in the *Qur'an* and the *sunnah*. These include the need for written contracts that stipulate terms and conditions fully and transparently, the direct and unequivocal admonition that commitments to the terms and conditions of contracts must be faithfully carried out, and the strong emphasis on trust, cooperation and consultation. Rules governing market behavior also create incentives—both positive and negative—to enforce honest, transparent and compliant behavior on the part of participants. Hence, risk-sharing contracts designed under Islamic rules would mitigate informational problems (Khan and Mirakhor 1987; Presley and Sessions 1994) and could be better structured than interest-based debt contracts with incentives to maximize both parties' expected joint rewards.

In comparing risk-sharing financing and debt financing, Presley and Sessions (1994: 587) propose to consider:

*. . . a single project undertaken by a single manager, the outcome of which is determined by the level of capital investment, the level of managerial effort, and the state of nature, which we envisage in terms of some random shock to demand or technology. We examine the situations where capital is financed through riba [debt] and mudarabah [profit/loss] based contracts respectively . . . The manager is assumed to have superior information to investors in two respects: First, having signed a contract with investors the manager is able to observe the demand or productivity conditions affecting the project before committing to production decisions; and second, he alone observes his personal level of effort. Such an asymmetry is not unusual and, indeed, rationalizes the manager's involvement in the project. But whilst the manager's relative informational expertise suggests that he should be delegated some authority over production decisions, the exploitation of this expertise is problematic. Since effort is private information, the manager cannot be compensated directly for its provision. A revelation problem therefore arises with the manager's preferences over productive inputs only coinciding with those of investors if he personally bears the entire risk of adverse shocks.*

In this situation, Presley and Sessions show that a profit/loss (*mudharabah*) contract between the agent and a group of investors may result in a more efficient revelation of any informational advantage possessed by the agent over the principals. Again, and as mentioned a number of times above, it should be noted that there is an important moral dimension to Islamic risk sharing, strengthening society by enhancing cooperation between principals and bringing agents and principals closer together.<sup>3</sup>

### Enhanced Cooperation among Economic Agents

When risk is spread by means of risk/reward-sharing contracts, closer coordination is forged between the real and financial sectors of the economy. Risk transfer by means of interest-based debt contracts, in contrast, weakens that linkage. Particularly when risk transfer is combined with high leverage, the growth of interest-based debt contracts and their pure financial derivatives—those with little or no connection to real assets—outpace the growth of the real sector, leaving the liabilities in the economy a large multiple of real assets needed to validate them. This phenomenon is called “financial decoupling” (Menkoff and Tolkorof 2001) or “financialization” (Epstein 2006; Palley 2007), whereby finance is no longer anchored in the real sector. The result is financial instability leading to frequent crises. Reinhart and Rogoff (2009) have catalogued the high frequency of historical occurrences of crises in the conventional interest-based system and have clearly shown that all crises, whether classified as a currency or banking crisis, have been at their core a debt crisis.

### Risk Sharing vs. Risk Transfer

Interest rate-based debt contracts have two major characteristics. First, they are instruments of risk shifting, risk shedding, and risk transfer. Second, in such contracts, the creditor acquires a property-rights claim on the debtor, equivalent to the principal plus interest and whatever collateral may be involved, without losing the property-rights claim to the money lent. This is a violation of Islamic property-rights principles as described in Chapter 2.

The “sharing of risk” has many possible meanings, depending on how risk sharing is organized. All forms of organized risk sharing have a “mutuality” dimension in their activities. The most familiar are cooperatives of various forms designed to share risk faced by their members. Producer, consumer and farm cooperatives allow members to share risks of production, consumption, crop output and related activities. In the case of Islamic insurance such as *takaful*, a group pools its resources to insure its members against risk. Ordinary insurance, where a person buys an insurance contract for a fee (indicated by a premium), is not an example of risk sharing but of “risk transfer,” where for a fee the insured transfers part of his/her idiosyncratic risks to a firm willing to provide protection against possible

contingencies. What is missing here is the element of mutuality. Each policyholder deals directly with the insurance company without the need to know any other policyholder. For instance, if plant catches fire in a factory, the owner does not have to bear the full cost of rebuilding the plant. The insurance company can cover this because it pools the resources of a large number of such policyholders. Since fires do not occur simultaneously in all insured firms, an insurance company is expected to be in a position financially to replace one or a number of destroyed plants.

### **Stability of the Financial System**

While, in our opinion, Islamic finance would be inherently stable (see Chapter 7) because it is structured on a foundation of equity financing and risk sharing, conventional finance, a debt-and-interest-based system, has proven to be unstable. Minsky has dubbed the instability of conventional finance as “endogenous instability” because conventional finance experiences a three-phased cycle: relative calm, speculation and fictitious expansion, and then crisis and bankruptcy. Bankruptcy in conventional finance is not limited to the private sector as governments can also face bankruptcy. Again, recent historical analysis has demonstrated that all financial, banking and currency crises are, at their core, a crisis arising from debt.<sup>4</sup> In the recent past, the widespread bankruptcies of many developing countries have entailed debt cancellation or forgiveness. This is often because governments that borrowed at what were considered reasonable debt levels (normally as measured by debt: GDP) later found themselves in an unsustainable debt spiral as a result of increased debt service obligations. Some countries even found themselves with debt levels many times larger than the original amount of borrowed principal.

These developments have helped the perpetuation of a system that a number of renowned economists, including Keynes, have deemed detrimental to growth, development and to equitable income and wealth distribution. More recently, a growing literature and proposed reforms have argued that the stability of a financial system can only be assured by limiting credit expansion and leveraging; this in turn requires the elimination of subsidies that fuel moral hazard, such as subsidized deposit insurance schemes and guarantees that support “too large to fail” institutions, and restrictions to limit the creation of money through the fractional-reserve conventional banking system. Islamic finance, based on risk sharing and limiting fractional-reserve banking, has been shown to be inherently stable and socially more equitable. In such a system, there is a one-to-one mapping between the growth of financial and real sector activities, meaning that credit cannot expand or contract independently of the real sector as in the conventional system. In other words, the real and the financial sectors are closely connected and cannot be decoupled as in conventional finance.

## HISTORY OF SHARING RISK IN ISLAM

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Islamic finance based on the sharing of risk has had a long history and was the dominant form of financing investment and trade in the Middle Ages. Even today, venture capital financiers use techniques very similar to Islamic contracts such as *mudarabah*. Conventional banking, which began with the goldsmiths' practice of fractional-reserve banking, has received strong financial subsidies from central banks as lenders of last resort, from government deposit insurance schemes and from tax treatments, rules and regulations which have heavily favored debt-based contracts over risk-sharing contracts. For these and other reasons, risk sharing is still at an early stage of development in all countries, to say nothing of its even more modest international application.

Beginning with Postan (1928), economic historians have indicated that these trade flows were supported by a financial system sustained by an expanding risk-sharing credit structure based on *commenda* and *maona*.<sup>5</sup> Postan's paper was ground-breaking in that it demonstrated that: (i) economists and historians had, until then, underestimated the growth of the volume of credit in the Middle Ages, and (ii) the bulk of this credit was either *commenda* or *commenda*-like, joint risk-sharing partnerships, even if they were "miscalled or modified" as loans (Postan 1928, 1957). As we saw in Chapter 4, there is little doubt that these and other financial instruments originated in the Islamic world and were spread through Europe by scholars during the Jewish Diaspora and by Islamic merchants in Spain. The Geniza records clearly show that: (i) trade in the Middle Ages was both extensive and intensive, financed by risk-sharing partnerships; (ii) partnership was used in industrial, commercial, and in public administration projects; (iii) the Mediterranean and Indian trade were largely not based on cash benefits or legal guarantees, but on the human qualities of mutual trust and friendship; and (iv) that lending money for interest was not only shunned religiously, but was also of limited economic significance.

Moreover, research by Medieval historians has demonstrated the extensive use of risk-sharing partnerships (Adelson 1960; Arfoe 1987; Ashtor 1975, 1976, 1983; Byrne 1920, 1930; Exenberger 2004; Laiou 2002; Lieber 1968; Lopez 1951, 1952, 1955). While risk-sharing techniques continued to prevail in Europe until the mid-seventeenth century, beginning in the mid-sixteenth century, the institution of interest-based debt financing also began to be used more widely and extensively throughout Europe (Munro 2003).

The explanation for the initial utilization of this method of financing and its dominance over risk-sharing methods has been a combination of several factors, including (i) the demise of the scholastic prohibition of usury (Munro 2003; Sauer 2002); (ii) the appearance and rapid growth of fractional-reserve banking that led to the specialization of finance by intermediaries who preferred to provide financing to agent-entrepreneurs at fixed interest rates based on contracts enforceable by law and the state in order to reduce



monitoring and transaction costs; (iii) the inflow of vast amounts of gold and other riches into Europe from the colonies in the Americas and elsewhere, which reduced the incentive for the elite classes to continue financing trade on the basis of risk sharing, preferring fixed-interest debt contracts; (iv) the emergence of nation-states whose governments needed finance for wars or other state activities, but could not raise resources except by means of fixed interest-rate contracts, according to which an annuity was paid in perpetuity without the need for governments to repay the principal (Michie 2007); and, most importantly, the process of securitization in the fourteenth century, an innovation that created a revolution in mobilizing financial resources (Michie 2007). It is likely, however, that the breakdown of trust in Europe and elsewhere was a major factor for the loss of dominance of risk-sharing finance by the end of the Middle Ages.

## CONCLUSION

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Islamic finance is all about risk sharing. It encourages risk sharing in its many forms but generally discourages risk shifting or risk transfer, in particular interest-based debt financing. It is, in part, so designed to promote social solidarity by encouraging finance to play an integrating role. This form of finance would be inclusive of all members of society and all entities, especially the poor, in enjoying the benefits of economic growth, and to bring humankind closer together through the sharing of risk. Since risk sharing is the foundation and a basic activity in Islamic finance, it is governed by rules that, if and when observed, lead to lower transaction costs than in conventional finance.

These rules ordain trust; demand faithfulness to the terms and conditions of contracts; command compliance and prohibit violations; encourage transparency and truthfulness in transactions; prohibit interference with market forces, such as through the hoarding of commodities to force price increases or through the formation of coalitions to influence prices and/or quantities; and market supervision to ensure compliance. These, plus others mentioned earlier, when observed, reduce the incidence of informational problems that plague the conventional interest-based financial system (Mirakhor 2007).

A further implication is that finance based on risk/return sharing means that the rate of return to finance is determined *ex post*, by the rate of return on real activity rather than the reverse, which is the case when interest-based debt contracts finance production. This has a further economic implication in that risk/return-sharing finance removes interest payments from the pre-production phase of an enterprise and places it in the post-production, after-sales, distributional phase. In turn, this has price–quantity consequences. It should be clear that compliance with the behavioral rules prescribed by Islam reduces risk and uncertainty, both of which are facts of human existence. When risks to income materialize they play havoc with people's

livelihood. It is, therefore, welfare enhancing to reduce risks to income and lower the chances of its volatility in order to allow consumption smoothing.

This is accomplished by risk sharing and risk diversification (Shiller 2003). By focusing on trade and exchange in commodities and assets, Islam promotes risk sharing. Arguably, it can be claimed that through its rules (institutions) governing resource allocation, property rights, production, exchange, distribution and redistribution, financial transactions, and market behavior, the Islamic paradigm orients all economic relations toward risk/reward sharing. This can be said to be a logical consequence of an insistence on the unity of mankind since Islamic finance promotes social solidarity through risk sharing. "Massive risk can carry with it benefits far beyond that of reducing poverty and diminishing income inequality. The reduction of risk on a greater scale would provide substantial impetus to human and economic progress" (Shiller 2003). The most meaningful human progress is achieved when all distinctions on the basis of race, color, income and wealth, and social-political status are obliterated to the point where humanity, in convergence with the declaration in the *Qur'an* (31:28), truly views itself as one and united. It can be argued that the implementation of Islamic finance will promote maximum risk sharing, and thus create the potential for enhanced social solidarity (Mirakhor 2007; Askari, Iqbal and Mirakhor 2009).

Arguably, the ideal Islamic finance paradigm points to a full-spectrum menu of instruments serving a financial sector imbedded in an Islamic economy in which all rules of market behavior prescribed by Islam are fully operational. The essential function of that spectrum would be the spreading and allocating of risk among market participants rather than allowing it to concentrate among the borrowing class. Islam proposes two sets of risk-sharing instruments: (i) *muamalat* risk-sharing instruments in the financial sector, and (ii) redistributive risk-sharing instruments used by the economically more able segment of society in order to share the risks facing the less economically able. As we have seen, these are not instruments of charity, altruism or beneficence: they are instruments for the redemption of rights and the repayment of obligations. Through its redistributive mechanisms, such as *zakat*, Islam incorporates the duty of sharing into all economic relations. In other words, Islam prescribes that the more able have the duty to share in the risks faced by the poor and vulnerable social classes. As part of its incentive structure, the *Qur'an* promises that these sharing arrangements, far from reducing income and wealth of the more able, increase income and wealth by multiples.<sup>6</sup>

## ENDNOTES

1. See, for example, 2:155, 29:2 and 9:126.
2. See, for example, *Al-Tahqiq Fi Kalamat Al-Quran Al-Karim; Lisan Al-Arab; Mufradat Alfaz Al Quran*, among others.
3. See Mirakhor and Askari (2010): 158–70; and Mirakhor (2010): 8–19.

4. See Reinhart and Rogoff (2009).
5. For a full discussion of Islamic financial instruments, see Iqbal and Mirakhor (2007).
6. “Allah will destroy *al-riba* and will reward in multiples deeds of sharing” [through redistributive mechanisms provided; acts that confirm and affirm belief and rule compliance] (*Qur’an* 2: 276).

## CHAPTER 6

# The Islamic Financial System

**T**he primary role of a financial system is to create incentives for an efficient allocation of financial and real resources for competing aims and objectives across time and space. A well-functioning financial system promotes investment by identifying and funding good business opportunities, mobilizes savings, monitors the performance of managers, enables the trading, hedging and diversification of risks, and facilitates the exchange of goods and services. These functions ultimately lead to the efficient allocation of resources, rapid accumulation of physical and human capital and faster technological progress, which, in turn, feed economic growth.

Within a financial system, financial markets and banks perform the vital functions of capital formation, monitoring, information gathering, and facilitation of risk sharing. An efficient financial system is expected to perform several functions. First, the system should facilitate efficient financial intermediation to reduce information and allocation costs. Second, it must be based on a stable payment system. Third, with increasing globalization and demands for financial integration, it is essential that the financial system offers efficient and liquid money markets and capital markets. And, finally, it has to have a well-developed market for risk trading, where economic agents can buy and sell protection against event risks as well as financial risks.

Research on financial intermediation and financial systems in the past two decades has enhanced our understanding of the significance of the financial system and the crucial role it plays in economic development. For example, studies have shown that countries with higher levels of financial development grow faster by about 0.7 percent a year. Between 1980 and 1995, 35 countries experienced financial crises. These were, essentially, periods during which the financial systems of these economies stopped functioning and, as a consequence, their real sectors were adversely affected, which led to recessions. Although strong evidence points to the existence of a relationship between economic development and a well-developed financial system promoting efficient financial intermediation through a reduction in information, transaction and monitoring costs, this linkage and the direction of causation

is not as simple and straightforward as it may seem. The form of financial intermediation, the level of economic development, macroeconomic policies, and the regulatory and legal framework are some of the factors that can complicate the design of an efficient financial system.

## **FINANCIAL SYSTEMS: A FUNCTIONAL VIEW**

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A financial system is better understood when viewed as a set of functions it performs in an economy. Where a traditional view of a financial system restricts its role to mere capital mobilization, a functional view expects it to perform an expanded role. By restricting the role of the financial system to capital mobilization, its deeper role under uncertainty, where risk allocation becomes critical, is ignored. In addition, given information asymmetries and incentive problems, capital markets may offer more efficient contracting through marketing for corporate control.<sup>1</sup> Another argument favoring a functional view is that the functions of a financial system do not significantly change over time and space, while the forms and functions of institutions and intermediaries are subject to change.

Although, the most fundamental role of a financial system is still financial intermediation, the following are the core functions expected from an efficient financial system.

### **Efficient Capital Mobilization**

The ultimate function of a financial system is to perform efficient resource allocation through capital mobilization between savers and users of capital. This function is performed efficiently when the economic agents have access to capital through a liquid market for varying maturity structures; that is, from the very short- to the very long-term needs. Access to capital has to be easy, transparent, and cost effective, with minimal transaction costs and free of information asymmetries.

### **Efficient Risk Allocation**

Under uncertainty and volatile market conditions, the function of risk sharing, risk transfer, and risk pooling becomes critical in a financial system. In the absence of such functionality, the financial system will discourage projects that attract high risk but also high value-added to the economy. The “insurance” function is vital for any financial system and the availability of efficient risk-sharing facilities promotes diversification and allocational efficiencies.

### **Pooling of Resources and Diversification of Ownership**

A financial system provides a mechanism for the pooling of funds to undertake large-scale indivisible investments that may be beyond the scope of

any one individual. They also allow individual households to participate in investments that require large lump sums by pooling their funds and then subdividing shares in the investment. The pooling of funds allows for a redistribution of risk as well as the separation of ownership and management.<sup>2</sup>

### **Efficient Contracting**

A financial system should promote financial contracting that minimizes incentive and agency problems arising from modern contractual arrangements among owners, managers, regulators, and other stakeholders. Both financial institutions and financial markets have distinct incentive problems arising from the conflicting interests of investors, managers, owners, and regulators. A financial system should therefore encourage financial contracting which minimizes distortion and enhances allocation efficiency.

### **Transparency and Price Discovery**

A financial system should promote the efficient processing of information such that all available information pertaining to the value of an asset is available at the lowest cost and is reflected in the value or price of the asset. This price-discovery function leads capital being allocated to the most productive use in the most efficient manner.

### **Better Governance and Control**

Advances in modern finance have highlighted the importance of good governance, especially with respect to financial institutions and markets. A financial system should facilitate transparent governance and promote discipline in management through external pressures or threats, such as takeovers, so that any misallocation and misappropriation is minimized.

### **Operational Efficiency**

A financial system should provide for the smooth operation of financial intermediaries and financial markets by minimizing any operational risk due to failures in processes, settlement, clearing, and electronic communication. The smooth and transparent execution of financial transactions develops reputation and “trust” among economic players and therefore is beneficial in attracting external resources. This is especially applicable in the case of emerging economies that are eager to attract foreign investors.

## **COMPONENTS OF THE ISLAMIC FINANCIAL SYSTEM**

A financial system comprises different sub-systems such as banking, financial markets and capital markets, and is underpinned by a legal and commercial

infrastructure. This section discusses the theoretical design of the banking-style financial intermediation and the capital markets when operating under the *Shari'ah* legal system. When compared to the conventional system, the Islamic financial system has two distinct features: first, as we have seen, the prohibition of *riba* results in the elimination of debt and, ultimately, opportunities to create leverage in the system. Second, the financial system promotes risk sharing through modes of transactions designed to share risks and rewards on more equitable grounds.

The Islamic financial system proposes a sound banking system which operates without debt and promotes financing of the real economy. The risk-sharing nature of the system means that stock markets play a vital role and are expected to form a large segment of the system. Where the conventional system is dominated by the debt market, followed by the banking sector and the stock market, in an Islamic system there is no debt market. Researchers have argued that the debt market has been replaced by an active and vibrant market of securitized assets, bears some resemblance to the conventional asset-based debt market but has its own distinct features that enable it to behave and operate differently.

### **The Banking System**

As discussed in the previous chapter, there are several contracts or instruments which facilitate financial intermediation and banking in the Islamic financial system. Although committed to carrying out their transactions in accordance with the rules of the *Shari'ah*, Islamic banks perform the same essential functions as banks in the conventional system. That is, they act as the administrators of the economy's payments system and as financial intermediaries. The need for them in the Islamic system arises precisely for the same reason as that in the conventional system. That is, generally, their *raison d'être* is the exploitation of the imperfections in the financial markets. These imperfections include the imperfect divisibility of financial claims, transaction costs associated with the search, acquisition, and diversification for the surplus and deficit units, and the lack of market expertise and economies of scale in monitoring transactions.

This brief review of the contracts available under the Islamic economic system leads us to conclude that transactional and financial contracts (as discussed in Chapter 4), coupled with intermediation contracts, offer a comprehensive set of instruments with varying financing purposes, maturities and degrees of risk, to satisfy the needs of diverse groups of economic agents in the economy. This set of instruments can be used to design a formal model for an Islamic financial intermediary (IFI) or an Islamic bank that can perform the typical functions of resource mobilization and intermediation. By utilizing this set of intermediation contracts, an IFI will be able to offer a wide array of commercial- and investment-banking products and services.

Formally, three theoretical models have been suggested for the structure of Islamic financial intermediation and banking. The first model is commonly

referred to as the “two-tier *mudarabah*” model, while the second model is known as the “two-windows” model. As mentioned earlier, a *mudarabah* is a principal/agent contract, where the owner of the capital (investor/depositor) forms a partnership with the owner of a specialized skill (professional manager or bank) to invest capital and to share the profits and losses of the investment. The third model is the *wikala*-based model, as discussed below.

**Two-tier *mudarabah*** This model is so called because the contract is utilized on each side of the bank’s balance sheet and integrates the assets and liabilities. It envisages depositors entering into a contract with a bank to share the profits accruing to the bank’s business. The basic concept is that both the mobilization and utilization of funds are conducted on the basis of profit sharing among the investor (depositor), the bank and the entrepreneur or the users of the funds. The first tier of the contract is between the investor (analogous to a depositor) and the bank, where investors act as suppliers of funds to be invested by the bank, which acts as the *mudarib* on their behalf. The investors share in the profits and losses earned by the bank’s business related to their investments. Funds are placed with the bank in an investment account.

The liabilities and equity side of the bank’s balance sheet thus shows the deposits accepted on a *mudarabah* basis. These investment deposits are not liabilities (the capital is not guaranteed and they incur losses if the bank does so) but a form of limited-term, non-voting equity. In this model, banks can also accept demand deposits that yield no returns and are repayable on demand at par; these are treated as liabilities. This model, though requiring that current deposits be paid at the demand of the depositors, has no specific reserve requirement.

The second tier represents the *mudarabah* contract between the bank, as supplier of funds, and the entrepreneurs, who are seeking funds and agree to share profits with the bank according to a certain percentage stipulated in the contract. The bank’s earnings from all its activities are pooled and are then shared with its depositors and shareholders according to the terms of their contract. Thus the profit earned by the depositors is then a percentage of the total banking profits. A distinguishing feature of the two-tier model is that, by design, the assets and liabilities sides of a bank’s balance sheet are fully integrated, which minimizes the need for active asset/liability management, which, in turn, provides stability against economic shocks. The model does not feature any specific reserve requirements on either the investments or the demand deposits.

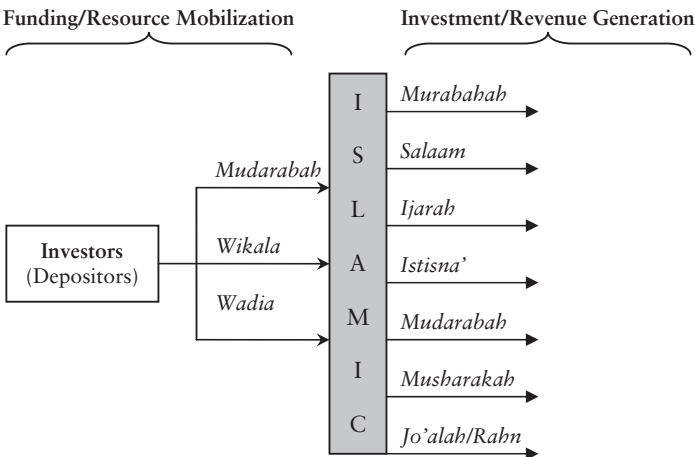
**Two-windows model** This model also features demand and investment accounts but takes a different view from the two-tier model on reserve requirements. The two-windows model divides the liabilities side of the bank’s balance sheet into two windows; one for demand deposits (transactions balances) and the other for investment balances. The choice of the window is left to the depositors. This model requires a 100-percent reserve



for the demand deposits but stipulates no reserve requirement for the second window. This is based on the assumption that the money deposited as demand deposits is placed as *amanah* (that is, for safe keeping) and must be backed by a 100-percent reserve, because these balances belonging to the depositors do not carry with them the innate right for the bank to use them as the basis for money creation through fractional reserves. Money deposited in investment accounts, on the other hand, is placed with the depositors' full knowledge that their deposits will be invested in risk-bearing projects, and thus no guarantee is justified. In this model, too, the depositors may be charged a service fee for the safekeeping services rendered by the bank. The provision of interest-free loans to those who may need them is limited to the funds deposited in such accounts by the depositors who think that the bank may be better equipped for this purpose. No portion of the deposits in the current account or investment accounts will be required to be used for this purpose.

**Wikala model** A third, but lesser-known, model for an Islamic bank has also been suggested. This model is based on the contract of *wikala* where an Islamic bank acts purely as *wakil* (agent/representative) of the investors and manages funds on their behalf on the basis of a fixed fee. The terms and conditions of the *wikala* contract are to be determined by mutual agreement between the bank and the clients.

Figure 6.1 shows a simplified version of how a typical Islamic bank can be structured to mobilize funding from the deposits and how the funds are invested in different instruments. The bank's relationship with the depositors could be based on a *mudarabah*, *amanah*, *wikala* or *wadia* basis on its liabilities side. However, on the assets side, the bank has more freedom and choices to invest depositors' investments. Islamic banks carry



**FIGURE 6.1** Islamic financial intermediation

*murabahah*, *ijarah*, *istisna'*, *mudarabah* and *musharakah* investments on their assets side.

The banks in the Islamic financial system can reasonably be expected to exploit economies of scale as their counterparts do in the conventional system. Through their ability to take advantage of these imperfections, they alter the yield relationships between the surplus and deficit financial units and thus provide lower costs to the deficit units and higher returns to the surplus units than would be possible with direct finance. Just as in the conventional financial system, the Islamic depository enables financial intermediaries to transform the liabilities of business into a variety of obligations to suit the preferences and circumstances of the surplus units. Their liabilities consist of investments/deposits and their assets consist mainly of instruments of varying risk/return profile. These banks are concerned with decisions relating to such issues as the nature of their objective functions, portfolio choice among risky assets, liability and capital management, reserve management, the interaction between the assets and liabilities sides of their balance sheets and the management of off-balance-sheet items—such as revolving lines of credit, standby and commercial letters of credit and bankers' acceptances.

Moreover, as asset transformers, these institutions become risk evaluators and serve as filters to evaluate signals in a financial environment with limited information. Their deposit liabilities serve as a medium of exchange and they have the ability to minimize the cost of transactions that convert current income into an optimal consumption bundle. One major difference between the two systems is that, given the prohibition against taking interest and the fact that they have to rely primarily on profit sharing, the Islamic banks have to offer their asset portfolios of primary securities in the form of risky open-ended "mutual fund"-type packages for sale to investors/depositors. In contradistinction to the Islamic system, banks in the conventional system keep title to the portfolios they initiate. These assets are funded by the banks through issuing deposit contracts, a practice that results in solvency and liquidity risks, since their asset portfolios and loans entail risky payoffs and/or costs of liquidation prior to maturity, while their deposit contracts are liabilities that are often payable instantly at par. In contrast, Islamic banks act as agents of investors/depositors and therefore create a pass-through intermediation between savers and entrepreneurs.

In short, Islamic financial intermediaries are envisioned to intermediate on a "pass-through" basis such that the returns (positive or negative) on the assets are passed to the investors/depositors. The intermediary will apply financial engineering to design assets with a wide range of risk–return profiles to suit the demands of the investors on the liabilities side.

## Capital Markets

Conventional capital markets can be broadly divided into three categories; (i) debt markets, (ii) equities or stock markets; and (iii) markets for structured securities which are hybrids of either equity or debt securities. Debt markets

dominate the conventional capital markets and debt is considered the major source of external funding for the corporate and public sectors. As the result of financial innovations and the application of financial engineering, large numbers of financial products have been developed for resource mobilization. Most of these innovations are variations on plain vanilla debt or equity security, with added options or customization.

In comparison, future Islamic capital markets will have two major categories; (i) stock market; and (ii) securitized “asset-linked” securities. Due to the prohibition of interest, the financial system will be free of any debt market and there will be clear preference for risk-sharing securities such as an exchange-traded stock market. After the stock market, a market for securitized securities issued against pool of assets which carry risk–return characteristics of underlying assets will be the major source of capital.

**Stock market** With the prohibition on interest and the preference for partnerships to share profits and losses, equity markets hold a significant place. Therefore, Islamic scholars have pointed out the necessity, desirability and permissibility of the existence of a stock market in the financial system of Islam in which transactions in primary capital instruments such as corporate stocks can take place. The conditions of the operations of these markets, in accordance with the rules of the *Shari’ah*, are much like those that prevail in markets for goods and services. For example, in such markets the rules are intended to remove all factors inimical to justice in exchange and to yield prices that are considered fair and just. Prices are just or equitable not on any independent criterion of justice, but because they are the result of bargaining between equal, informed, free and responsible economic agents. To ensure justice in exchange, the *Shari’ah* has provided a network of ethical and moral rules of behavior for all participants in the market and requires that these norms and rules be internalized and adhered to by all. Given that a proper securities underwriting function is performed by some institutions in the system (the banks, for example), the firms could then raise the necessary funds for their investment projects directly within the stock market, which would provide them a second source of funding other than the banks.

A stock market operating strictly in accordance with Islamic rules is envisioned to be one in which the disposal of investible funds is based on the profit prospects of the enterprises, in which relative profit rates reflect the efficiencies between firms, and in which profit rates (as signals coming from the goods market) are not distorted by market imperfections. Such a market might be expected to allocate investible funds strictly in accordance with expected investment yields; that is, resources would be allocated in order to finance higher-return projects. Stock markets would also be capable of improving allocation of savings by accumulating and disseminating vital information in order to facilitate comparisons between all available opportunities, thus reflecting the general efficiency in resource allocation expected from a system that operates primarily on the basis of productivity of investment.

If we assert that Islamic finance is all about risk sharing, then the best instrument for this is a stock market “which is arguably the most sophisticated market-based risk-sharing mechanism” (Brav *et al.* 2002). Developing an efficient stock market can effectively complement and supplement the existing and future array of other Islamic finance instruments. It would provide the means for business and industry to raise long-term capital. A vibrant stock market would allow the risk diversification necessary for managing aggregate and idiosyncratic risks. Such an active market would reduce the dominance of banks and debt financing where risks become concentrated and create system fragility (Sheng 2009).

Idiosyncratic risks have a potential impact on the liquidity of individuals. With an active stock market, individuals can buffer idiosyncratic liquidity shocks by selling equity shares on the stock market. Firms too can reduce their liquidity risk through active participation in the stock market and can reduce risks to the rate of return to their own operation—such as productivity risk—by holding a well-diversified share portfolio. Thus incentives are created for investment in more long-term, productive projects. Importantly, by actively participating in the stock market, individuals and firms can mitigate the risk of unnecessary and premature liquidation of their assets due to liquidity and productivity shocks (Pagano 1993). Moreover, an active and vibrant stock market creates strong incentives for a higher degree of technological specialization, through which the overall productivity of the economy is increased. Without sufficiently strong risk sharing through participation in the stock market, firms avoid deeper specialization, fearing the risk from sectoral demand shocks (Saint-Paul 1992).

The reason stock markets are such an effective tool for risk-sharing purposes is that each share represents a contingent residual equity claim. In the case of open corporations, in particular, their common stock are “proportionate claims on the pay offs of all future states” (Fama and Jensen 1983). These returns are contingent on future outcomes. Stock markets that are well-organized, regulated and supervised are efficient from an economic viewpoint because they allocate risks according to the risk-bearing ability of the participants. A solution to the problem of how best to allocate the risks of the economy was provided by the famous Arrow-Debreu model of competitive equilibrium (1954; see also Arrow 1972). According to this model, efficient risk sharing requires that the risks of the economy are allocated among participants in accordance with their “respective degree of risk tolerance” (Hellwig 1998).

An economy in which there are contingent markets for all commodities—meaning that there are buyers and sellers who promise to buy or sell given commodities “if and only if” a specified state of the world occurs—is known as an Arrow-Debreu economy. In such an economy, it is the budget constraint of the participants that determines how much of each contingent commodity they can buy at prevailing market prices. Since these commodities are contingent on future states, they are risky. Therefore, individual budget constraints determine the risk-bearing ability of each market participant. Arrow himself

recognized that requiring such a market is unrealistic: “Clearly, the contingent commodities called for do not exist to the extent required, but the variety of securities available on the modern markets serve as a partial substitute” (Arrow 1972). Such securities are referred to as Arrow Securities. They are contingent securities; they promise a certain amount of money to be delivered if a given state of the world obtains and nothing otherwise. The use of Arrow Securities, whose payoffs could be used to purchase commodities, would reduce the number of markets required while replicating the efficiency of the risk allocation of complete contingent markets. Associated with complete markets are complete contracts. These are agreements contingent on all states of nature. In the real world, not all contracts can cover all future contingencies. Therefore, they are said to be incomplete contracts and may indicate inefficiencies in exchange. However, as suggested above, optimal contracts can be devised provided there is mutual trust between the parties to the contract. That would be a simple contract with provisions for modifying the terms and conditions should contingencies necessitate change.

Not all Arrow Securities would satisfy *Shari’ah* requirements as some may well represent contingent debt contracts to deliver a fixed predetermined amount of money if a given state of the world occurs. These may not, therefore, represent an ownership claim either. Shares of common stock of open corporations do meet these requirements. They are residual ownership claims and receive a proportionate share of net returns contingent on future outcomes. The Arrow-Debreu model had other assumptions, such as no transaction costs and full information, which are also violated in the real world. Arrow recognized this limitation as well, suggesting that the model “is as much a normative ideal as an empirical description. It is the way the actual world differs from the criteria of the model which suggests social policy to improve the efficiency with which risk-bearing is allocated” (1972: 127), meaning that government action may become necessary “to improve the efficiency with which risk-bearing is allocated.” Moreover, Arrow emphasized that the model is about efficient allocation. It does not and cannot mean optimal distribution. It is possible to have an efficient economy but poor distributional results. The need for government intervention to correct for “the way the actual world differs from the criteria of the model” has echoes in a large body of research that focuses on these deviations—for example, market-failure literature—and suggests ways and means of correcting these shortcomings with government policy actions (see, for example, Stiglitz 1989; Arndt 1998).

Financing a portion of a government’s budget through the stock market, instead of resorting to debt financing as is the practice the world over, has advantages, including the following:

- It can energize a stock market—provided that all preconditions regarding human capital, legal, administrative and regulatory framework are met—and helps strengthen the credibility of the market.
- It deepens and broadens the stock market.

- It demonstrates that stock markets can be used as a tool of risk and financial management.
- It reduces reliance on borrowing, thus imparting greater stability to the budget and mitigating the risk of “sudden stops.”
- It has a positive distributional effect in that the financial resources that would normally go to service public debt can now be spread wider among the people as returns to the shares of government projects.
- It enhances the potential for financing a larger portfolio of public-goods projects without the fear of creating an undue burden on the budget.
- It makes the task of monetary management simpler by limiting the amount of new money creation.
- It promotes ownership of public goods by citizens. This should have a salutary effect on the maintenance of public goods as it creates an ownership concern among the people and to some extent mitigates “the tragedy of commons.”
- It has the potential to strengthen social solidarity.
- It also has the potential to promote better governance by involving citizens as shareholder-owners of public projects.
- It provides an excellent risk-sharing instrument for financing long-term private-sector investment.
- It is also an effective instrument for firms and individuals to use to mitigate liquidity and productivity risks.
- By providing greater depth and breadth to the market and minimizing the cost of market participation, governments convert the stock market into an instrument of international risk sharing, as other countries and their people can also invest in the market.
- It will help demystify Islamic finance and will create an environment of cooperation and coordination with international finance.

The design of risk-sharing instruments to be issued by governments is not difficult. These instruments can be traded in the secondary market if the shareholders experience a liquidity shock. Their rate of return can be structured as an index of return tied to the rate of return of the stock market. If the domestic stock market is not deep, then an index of regional and/or international stock market returns can be included. The argument is that since social rates of return to public goods are much higher than to privately produced goods and services, the investment in public goods should have a rate of return at least as high as the return to the stock market to promote efficient resource allocation. Of course, since governments are usually less risky, the rate of return to government-issued shares has to be adjusted downward to take account of governments' risk premium. Depending on the country and the interest rate its government pays on borrowed money, it is not likely that the rate of return it would pay to holders of equity shares it issues—adjusted for the credit rating of the government as reflected in lower risk—would be any higher than the rate of interest. Even in the unlikely event that a few basis points more have to be paid, the tradeoff would be

worthwhile considering the positive contributions the instrument would make to the economy and to society.

**Securitized “asset-linked securities” market** In addition to the standard stock market, there is another capital market that provides a platform for trading asset-linked securities. The notion in Islamic finance of binding capital closely and tightly to a real asset encourages the issuance of securities against a portfolio of assets. For example, an asset financed through *ijarah* or *istisna’* can be used as collateral to issue securities linked to the payoffs and cash flows generated by the underlying assets. The assets of an Islamic financial intermediary based on *ijarah* or *istisna’* have interesting features. First, it provides a wide range of maturity structure; that is, from short-term trade financing to medium-term lease-based assets. A second and equally important feature is that the risk profiles of such assets carry relatively low credit risk because the payoffs are directly linked to the predetermined cash flows. Finally, predetermined cash flows and fixed maturities make these securities a close substitute for fixed-income securities which could be desirable to some investors. A portfolio of such assets could be securitized to create a financial security that can be traded on an organized capital market, in both the primary and the secondary markets.

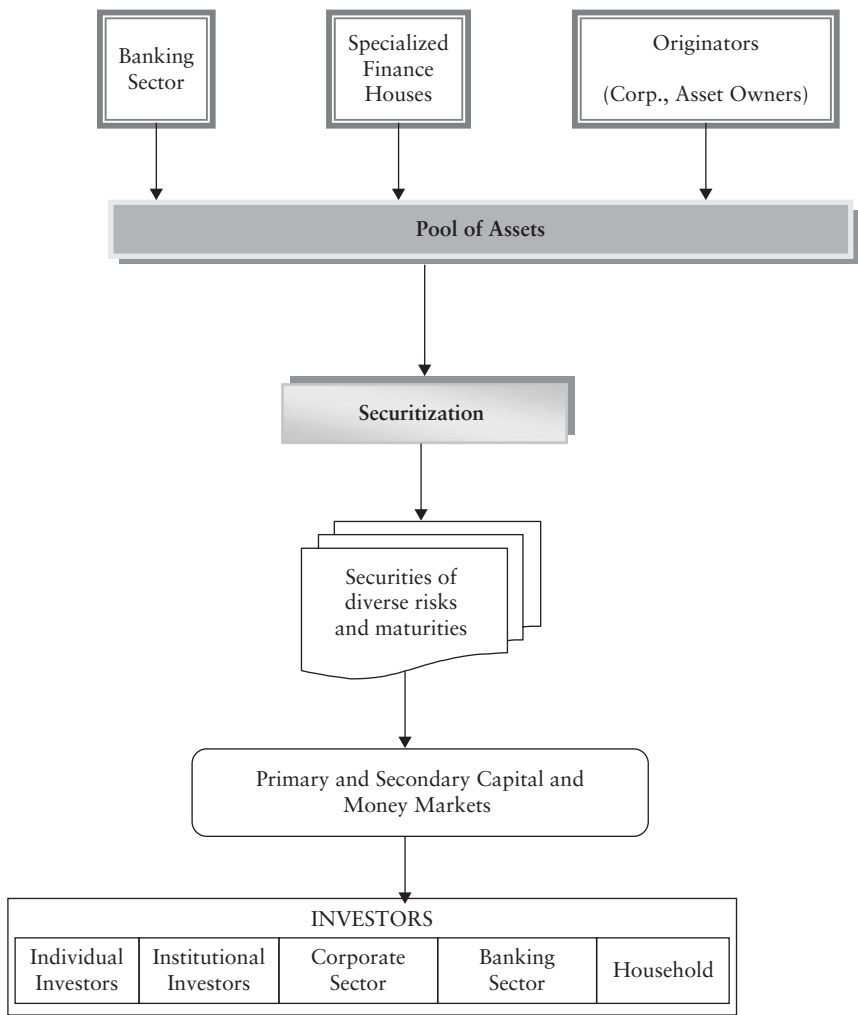
The securitization technique has been criticized in the conventional system in the aftermath of the financial crisis of 2007–08 where securitized securities with complex embedded derivatives led to the meltdown. A serious postmortem of the crisis will probably exonerate the process of “securitization” as such and will put the blame elsewhere. The technique of securitization by which a marketable security is developed that is backed by the payoffs of the underlying asset has a number of merits. As will be discussed below, a judicious application of securitization can lead to the development of a vibrant market for “asset-linked” securities which can play a critical role in the financial system.

Securitization involves collecting homogenous assets with a known stream of cash flows into a pool, or portfolio, which is independent of the creditworthiness of the financier. This pool of assets is used to issue securities, which can be marketed to different classes of investors ranging from individuals to institutional investors. The securities are structured in such a way that all payoffs in terms of risks and returns are “passed-through” to the investors or the holders of the securities. The net result is that it is as if the investor has the direct ownership of underlying assets, shares the returns of the assets and, finally, is exposed to all the associated risks. These securities are, in turn, traded and negotiated freely on organized exchanges.

The process described above is readily and directly applicable to the development of securitized securities in an Islamic financial system. The point of departure from the conventional system depends on the way the returns and risks are shared with or passed on to the investors. A securitized security in the conventional system is referred to as an asset-backed security because, in most cases, the security owner is exposed to the credit risk of the

guarantor and to the risk to the underlying asset’s returns and risks; or, in other words, the risks/returns of the underlying assets do not “flow” back to the security owner. Although the security is *backed* by the assets in the pool, its payoffs are not *linked* to the security risk/return profile. Arising from this distinction, we argue that a securitized security in Islamic finance will be designed to be linked to the payoffs of the underlying asset and we therefore refer to such securities as “asset-linked” securities.

Figure 6.2 shows the process of securitization of asset-linked securities. Different financial intermediaries and economic agents will hold assets



**FIGURE 6.2** The structuring of asset-linked securities



which can qualify to be pooled together and the holders of these assets may desire to sell these assets in the market for various valid reasons. For example, Islamic banks may have accumulated a portfolio of leases (*ijarah*) which it can sell through securitization to free up its investible funds. Similarly, a specialized finance house or corporation can offer assets to be securitized.

The pool of assets is converted into marketable securities through the process of securitization which can be carried by either specialists in securitization or by an Islamic financial intermediary. The process of securitization ensures that the security is structured to match the risk and return profile demanded by diverse group of investors. For example, some investors may have a lower risk appetite than others or may be looking for longer maturities. The structuring of the security will ensure that the designed security is attractive to the investor and offers portfolio management and diversification benefits.

These asset-linked securities are traded in the market through competitive bidding to the pool of investors, which includes individuals, Islamic bank portfolios, institutional investors such as pension funds or insurance funds, and corporate treasuries. The investors trade these securities in primary and secondary markets. There is no reason to believe that the targeted investors will be limited to Islamic investors the risk/return profile of the security may also be attractive to conventional investors. The great interest in mortgage-backed securities in the conventional system shows the appetite for securitized products.

Table 6.1 lists the main differences between the conventional and Islamic securitized securities. In the former, the resultant security is a debt security with a predetermined stream of coupon payments and where principal is guaranteed (often through formal credit guarantees). In the latter, the security's cash flow stream will depend on that of the underlying asset and the principal will not necessarily be guaranteed. It is possible that in some cases, depending on the underlying asset, the security owner may have a high certainty of full repayment of principal but it may not be guaranteed.

The holder of a conventional asset-backed security does not own the underlying asset but the ownership control in an asset-linked security will be higher. The asset ownership is also determined by how much recourse the security owner has to the underlying asset. One of the major differences between the two types of securities is the variables used in the pricing. In a conventional mortgage-backed security, the typical pricing model uses variables such as probability of prepayment or refinancing, which depend on the expected interest-rate levels in the future, loan-to-debt ratio, the credit rating of the borrower, and so on. Since its principal is guaranteed through credit-enhancing mechanisms, the security is priced like a coupon-bearing debt security with an early prepayment option. In the case of an Islamic security, however, the price will depend on typical variables determining the expected periodic cash flows in the future but will also have to factor in the expectation of the future market value or the residual value of the underlying asset. In the absence of any guarantee of principal, the redemption value

**TABLE 6.1** Comparison of conventional and Islamic securitized securities

	Conventional asset-backed security	Islamic asset-linked security (Theoretical—not current practice)
Security type	Fixed income (debt-based)	Hybrid depending on the contract and underlying assets. Could be quasi fixed income or risk sharing or both
Ownership	Security holder does not own the asset but owns a security against the asset	Security holder has ownership interest in the underlying asset
Recourse	Security holder does not have recourse to the asset in the event of distress	Security holder has recourse to the underlying asset in the event of distress
Pricing variables	Based on expected yields, current interest rates, and other variables influencing the asset owner's decision-making to prepay or refinance. Creditworthiness of asset owner or the guarantor influences prices	Based on expected yields, current levels of returns, market value of underlying assets, and expected value of the underlying asset at maturity
Linkage with asset value	No direct link to the market value of the underlying. Indirect variables such as loan-to-value (LTV) ratio are used as proxy.	In general, final or other payoffs may be linked to market value of the underlying asset.
Principal protection	Principal is protected irrespective of the value of underlying assets	Principal is linked to market value of underlying
Risk shifting	Risk transfer	Risk sharing

of the security will depend on the expected market value of the asset at the time of maturity of the security.

Finally, due to multiple layers of origination and credit enhancements, the risks are transferred to a third party in the event of a default. The risk sharing is minimized and investors are protected from the performance of underlying assets but are still exposed to the creditworthiness of the guarantor. In an asset-linked security, the price of the security will incorporate the riskiness of the underlying assets and the investor will be sharing

the risk through fluctuations in the security's price. The investors will be exposed to the risks of the asset portfolio and will share the losses rather than being exposed to the creditworthiness of the guarantor. This will put greater emphasis on the need for prudent selection of underlying assets, close monitoring of asset performance, and encourage securitization specialists to structure high-quality securities which offer valuable and secure investment opportunities.

Given that Islamic capital markets are based on a vibrant stock and asset-linked securities market, the door is open for the investors to apply portfolio management techniques to develop optimized portfolios with an unlimited number of different risk–return profiles. Whereas the stock market may have higher volatility, asset-linked securities are expected to exhibit less variance and thus provide vast diversification benefits. The markets complement each other, have different investor characteristics, and serve as venues for resource mobilization.

Table 6.2 provides a comparison of a stock market security and an asset-linked security.

**TABLE 6.2** Comparison of stock and asset-linked security

	Stock-market security	Asset-linked security
Risk	Business risk	Asset risk Credit risk
Collateral	Business assets (tangible and intangible) Equity capital	Underlying assets
Returns	Depends on business growth and earnings; residual claim on assets	Depends on cash flows of underlying assets
Cash flows	Less predictable	Deterministic
Volatility	Medium to high, subject to sector or business volatility	Mostly low but could be medium to high depending on the nature of securitization and degree of risk sharing
Contractual agreement	Equity share Capital ownership	Diverse, ranging from leases (rental) to equity (risk-sharing). Could be amortizing or rental stream or pass-through
Recourse	None. Last claim on residual assets	Ownership of underlying assets
Pricing	Based on the expected growth and the earnings of the business	Creditworthiness of asset holder and the market value of underlying asset

The success of an asset-linked securities market will largely depend on the supply and variety of assets, and on the ability to innovate security structures with distinct features such as return, risk, maturity, creditworthiness, geographical exposure, sector (technology, manufacturing, etc.) exposure, and currency exposure. It can be argued that, as the underlying pool of Islamic assets expands, a vibrant market for securitized securities will develop and in its fully developed form such a market will offer great opportunities for portfolio and risk management to all classes of investors.

From this, the following conclusions about the capital markets can be drawn:

- The elimination of debt markets will not deprive investors of diverse investment opportunities.
- Asset-linked securities offer a better value proposition than the plain debt security.
- With the application of financial engineering or spanning, the capital market can develop securities and financial products with the full spectrum of risk profiles.

## Derivative Markets

No discussion of financial systems can be complete without a mention of derivative markets, which perform the following three main functions:

1. **Risk reduction and redistribution:** It is widely accepted that the primary function of the derivatives market is to facilitate the transfer of risk among economic agents. Financial derivatives unbundle the risks associated with traditional domestic and cross-border investment vehicles, such as foreign exchange, interest rate, market, credit, and liquidity risks. Derivatives facilitate the redistribution of these risks from those who do not want or are not capable of hedging them to those who are in a better position to manage them.
2. **Price discovery and stabilization:** The existence of derivatives markets for futures and options is expected to increase information flows into the market and is known to lead to a price-discovery function in the financial sector.
3. **Completeness of markets:** Another critical function of the derivatives market is that it can enable individuals and firms to customize and monetize payoffs that might not otherwise be possible without considerable transaction costs.

Research on the scope of derivative securities and trading of risk in an Islamic financial system is in its early stages. *Shari'ah* scholars are working on assessing the permissibility of derivatives such as forwards, futures, options and swaps. Unlike financing and investment instruments, which have been in existence for several centuries and, therefore, have been taken up

by *Shari'ah* scholars, financial derivatives as independent financial contracts that can be traded have no precedents in classical Islamic jurisprudence. As a result, the research in this area is still evolving. While there have been a number of studies, these have not resulted in any concrete conclusions.

The majority view of *Shari'ah* scholars is that an option is a promise to sell or purchase a thing at a specific price within a stipulated time, and such a promise cannot be the subject of a sale or purchase. As the resolution of the Islamic Fiqh Academy, Jeddah, asserts:

*Option contracts as currently applied in the world financial markets are a new type of contract which do not come under any one of the Shari'ah nominate contracts. Since the subject of the contract is neither a sum of money nor a utility nor a financial right which may be waived, the contract is not permissible in Shari'ah.*<sup>3</sup>

These objections are based on the prohibition of *mysir* and *gharar*. The *Qur'an* prohibits speculative risk, warning the faithful to avoid games of chance in which the probability of loss is much higher than the probability of gain. Conventional finance argues that speculators play an important role in price discovery and price stabilization, but what it does not recognize is that excessive and large-scale speculation can become a factor for instability in the system. In Islam, gambling of any form is strictly discouraged on the grounds that it does not create value in society and an addiction to gambling is detrimental to economic growth.

In short, the debate on derivatives will continue but, at present, they have very limited acceptability in Islamic finance and are unlikely to be as widespread as in conventional markets in the near future. However, as Islamic finance grows, its own version of hedging mechanisms and financial products with embedded options will emerge. The prohibition of derivatives, however, does not preclude an Islamic financial intermediary from designing a risk-sharing or risk-mitigating scheme. This can be achieved through the creation of a risk-mitigating instrument synthetically using existing instruments. While it was shown in Chapter 5 that Islamic financial instruments promote risk sharing across the system, there will be opportunities for financial intermediaries to utilize these contracts and the freedom to contract in designing products and services to hedge against exposures.

### **Primary, Secondary and Money Markets**

The development of a secondary market is important and essential to the development of a primary market. All savers, to some degree or another, have a liquidity preference. This liquidity preference, although perhaps to a different extent and magnitude, can exist in an Islamic system or in any other system. To the extent that savers can, if necessary, sell securities quickly and at low cost, they will be more willing to devote a higher portion of their savings to long-term instruments than they would otherwise. Since

the probability is high that primary securities in the Islamic system would be tied to the projects and management of particular enterprises, there are various risks—those relating to the earning power of the firm and of its default, for example—that must enter into the portfolio decisions of savers.

There is another class of risk that is closely tied to the secondary market for a given security. If two securities are identical in all respects except that one has a well-organized secondary market while the other has a poor one, investors in the latter run the risk of liquidating their securities holdings at depressed prices compared to the prices offered for the former. Moreover, the degree of this marketability risk is directly related to factors such as the extent of the knowledge of the participants as well as the number of traders in the market, which determine the depth and the resilience of the secondary markets.

In an Islamic system, perhaps more than in any other, both the primary and secondary markets require the active support of the government, the central bank and regulators, not only in their initial development and promotion but also in their supervision and control, in order to ensure their compliance with *Shari'ah*. In secondary markets, in particular, traders and market-makers need the support and supervision of the central bank if the markets are to operate efficiently. For secondary markets to be able to transform an asset into a reliable source of cash for an economic unit whenever the latter needs it, they must be dealer markets, in which there is a set of position users who trade significant amounts of assets. In the traditional interest-based system, these position takers are financed by borrowings from banks, financial intermediaries, and other private cash sources. Since in the Islamic system refinancing on the basis of debt is not permitted, reliable and adequate sources of funds must be provided by the central bank. There will have to be arrangements through which the central bank and the regulator can, at least partially, finance secondary markets and supervise them fully.

In a conventional interest-based system, the money market becomes a means by which financial institutions can adjust their balance sheet and finance positions. Short-term cash positions, which exist as a result of imperfect synchronization in the payment period, become the essential ingredient for the presence of the money markets. The money market, in this case, becomes a source of temporary financing and an abode of excess liquidity in which transactions are mainly portfolio adjustments, and no planned or recently achieved savings need be involved.

In an Islamic financial system, the liabilities that an economic unit generates are, by necessity, closely geared to the characteristics of its investment. On the other hand, the liabilities that financial intermediaries generate are expected to have nearly the same distribution of possible values as the assets they acquire. Hence, given that debt instruments cannot exist, money market activities will have different characteristics from their conventional counterparts. As stated earlier, the existence of a poorly organized money market combined with a poor structure of financial intermediation leads to

a situation where money becomes more important as a repository of wealth than would be the case with more active financial intermediation.

The existence of broad, deep, and resilient markets in which the assets and liabilities of financial intermediaries can be negotiated is a necessary feature of supportive money markets. Additionally, to the extent that money markets lower the income elasticity of demand for cash and finance investment projects, their importance in an Islamic financial system cannot be overlooked. Even in this system, money markets will enable financial units to be safely illiquid, provided they have assets that are eligible for the money market. In this system, too, the basic source of the money in the market is the existence of pools of excess liquidity. One main activity of money markets in this system is to make arrangements by which the surplus funds of one financial institution are channeled into profit-sharing projects of another. It is conceivable that, at times, excess funds may be available with some banks, but no assets, or at least assets attractive enough in their risk–return characteristics, on which they can take a position. On the other hand, there may be banks with insufficient financial resources to fund all available opportunities, or with investment opportunities requiring commitments of what the banks may consider excessive funds in order for them to take a position and for which they may prefer risk sharing with surplus banks. In such a case, the development of an interbank funds market is a distinct possibility. It may also be possible for some banks to refinance a certain position that they have taken by agreeing to share their prospective profits in these positions with other banks in the interbank funds market. Finally, since most of the investment portfolios of banks will contain equity positions of various maturities, it is also possible that a subset of their asset portfolios comprising equity shares can be offered in the money market in exchange for liquidity.

Here, too, effective and viable money markets in an Islamic system will require active support and participation by the central bank, particularly at times when the investment opportunities and/or the risk–return composition of projects and shortages of liquidity in the banking system may require a lender of last resort. Such money markets must be flexible enough to handle periods of cash shortage for individual banks, based on some form of profit-sharing arrangement. The challenge for money markets, as well as for the secondary markets, in an Islamic financial system is the development of instruments that satisfy the liquidity, security and profitability needs of the markets while, at the same time, ensuring compliance with the rules of the *Shari'ah*—that is, the provision of uncertain and variable rates of return on instruments with corresponding real-asset backing.

### **EFFECT ON SAVINGS AND INTERMEDIATION**

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It can be argued that in an Islamic economic system, particularly with its emphasis on hard work and moderation in consumption, savings would be enhanced. Moreover, it seems intuitively plausible that since, in normal

circumstances, the rate of return on an investment must, generally, be higher than the rate of interest paid to depositors, replacing interest rates with a rate of return should increase the reward on savings. Consequently, insofar as saving is responsive to reward, incentives would be created for increasing savings (it should be noted that an increase in return to depositors is a function of the share parameter negotiated between the banks and their depositors on the one hand, and that negotiated between the banks and their customers—that is, agent-entrepreneurs—on the other).

Concerns have been expressed, however, that the adoption of an Islamic financial system may lead to a reduction in savings and the retardation of financial intermediation and development. This assertion is based on three different arguments. One argument suggests that since, in an Islamic system, the individual's income is subject to ordained levies, their savings will be lowered. The second argument asserts that since savings receive no reward from interest rates, there is no incentive for individuals to save. The third argument maintains that savings will decrease because of increased uncertainty of future prospects for Islamic financial systems. For the first argument to hold, it must be assumed that the ordained levies in the Islamic system are, in fact, larger than the numerous taxes that income and wealth are subjected to in other systems; this assumption ultimately requires empirical validation, but *prima facie* it appears to be baseless. But even if such an assumption were to be true, the next point to consider is the fact that these levies are transfers from groups with a low marginal propensity to consume to those with a higher marginal propensity. The question is whether or not, as a result of this transfer, aggregate demand will get sufficient impetus so as to increase investment, employment and income, so that aggregate saving is also enhanced, particularly in a demand-constrained economy.

The second argument stems from a misunderstanding about Islam's prohibition against interest. It is thought that this prohibition is tantamount to an imposition of a zero rate of return on investment and capital. This view clearly reflects confusion between rate of return and rate of interest. While the latter is forbidden in Islam, the former is not only permitted but is, in fact, encouraged.

The third argument is based on the proposition that increased uncertainty in the rate of return affects savings adversely. This view, however, is neither unique to an Islamic system nor unknown in the conventional economics literature. Alfred Marshall, for example, maintained, on the basis of casual observation, that uncertainty tends to reduce savings. Only recently has this question been subjected to rigorous theoretical analysis, with conflicting results. The few studies that have analytically or otherwise considered this question within the context of the Islamic framework have tended to neglect the risk–return tradeoff aspects of the question. That is, the effects on savings of a fixed and certain rate of return are compared with effects on saving when only uncertainty is taken into account. The result shows a reduction in savings. It should be obvious that if the expected value of return is kept constant while its variance is increased—that is, when increased risk



is not compensated by higher returns—savings will be adversely affected. This conclusion is, however, far from obvious when both risk and return are allowed to vary. The theoretical conclusion of an analysis in which risk and return variability have both been taken into account depends on assumptions regarding the form of the utility function and its risk properties, such as the degree and the extent of risk aversion, the present future discount and the degree to which the future is discounted, whether or not increased risk is compensated by higher return and, finally, the income and substitution effects of increased uncertainty. It has been shown, for example, that when future non-capital income is subjected to risk, decreasing temporal risk aversion is a sufficient condition for increased uncertainty about future income to decrease consumption and increase savings. With respect to capital income, the combined substitution and income effects of increased uncertainty are indeterminable. Other studies have shown that under reasonable assumptions, in face of uncertainty, there does exist a precautionary demand for savings. The theoretical analysis has not, thus far, provided a clear-cut hypothesis in this regard and it becomes an empirical question whether savings will increase or decrease in an Islamic system. It can, however, be reasonably expected that *a rational planner may make more provision for the future when the future becomes more uncertain*; an expectation which, *prima facie*, cannot be contradicted by any of the features underlying an Islamic economic system.

It has already been indicated that incentives exist in an Islamic system for efficient intermediation, and system characteristics, most importantly the prohibition against interest, create an important opportunity for the integration of financial markets. Since legislative action would make the charging of interest illegal and society's value-orientation would create a stigma for those charging interest, unorganized markets could not operate on the basis of interest. They would have to allocate their resources on the basis of profit sharing and it would be their relative ability and efficiency in exploiting market imperfections, *vis-à-vis* that of organized markets, that would determine how much of financial activities would be carried out by the unorganized markets.

The productivity of small-scale investment, the extent of the familiarity with agent-entrepreneurs and their ability to closely monitor projects, may still allow unorganized financial markets to exist, but it can be reasonably expected that the spread between the rates of return in an organized and an unorganized market would not be as wide as that which exists in the two markets in an interest-based developing economy where the organized financial sector is regulated and interest rates are kept artificially low.

It can be stated, however, that the other problems plaguing the financial development of most developing countries, such as discrimination against small and indigenous entrepreneurs, the shallowness of financial markets and the limited availability of asset choices for savers will not be automatically eliminated by the introduction of an Islamic financial system. In fact, the introduction of an attractive and varied menu of asset choices will,

## STATEWIDE IMPLEMENTATION: LESSONS LEARNT

The process of making the economic and financial system compatible with Islam was undertaken in the Islamic Republics of Iran, Pakistan and Sudan (though under different political, economic, and cultural circumstances). In each case, this process was not undertaken in a carefully thought-out manner and with the understanding of Islamic principles and jurisprudence but, rather, in an ad-hoc fashion. A thorough examination and evaluation of the experience in each country would take a separate volume but some of the reasons for the lack of success are summarized below:

- Implementing a banking system merely by removing interest from the system without preparing the groundwork of financial liberalization and strengthening the necessary institutions required by Islam (such as those that protect property rights and enforce contracts) is not realistic. Modern banking and financial systems require a sound legal infrastructure to support the system. Full implementation of the Islamic system demands conformity of the legal environment with the rules of the *Shari'ah*. The task of introducing changes in the common and civil law, regulations and investors' rights is a massive task, which often does not get priority in countries where there is social and political instability.
- The institutional infrastructure for development of an efficient financial system did not exist. Institutions designed to promote transparency, to protect the rights of creditors and to encourage good governance were either non-existent or too weak to be effective.
- The economies of these countries are still developing. There are significant budget deficits and government involvement in borrowing leads to inefficiencies in the economy, putting strain on the banking and financial sectors.
- In some cases, there was a lack of political will. Transforming the financial system is not an easy task and therefore requires commitment and support from the political forces in the country. In Pakistan, for example, the process of Islamization was started by a military regime but was not taken seriously by subsequent governments.

There is a great shortage of expertise and skills in the financial sector. These shortages hamper the development of new products. In addition, it is hard to find knowledgeable people trained in *Shari'ah* as well as in the domains of economics and finance.

perhaps, be far more important in the mobilization of savings in an Islamic system than in a conventional interest-based system. Moreover, effective financial intermediation requires more-efficient resource allocation in an Islamic financial system. It can be expected that the monitoring costs would be higher, and the need for specialization and expert portfolio diversification and management far greater, at least in the initial phases of operation after the adoption of the Islamic system, than in a conventional interest-based system. While the integration of financial markets should present no difficulties in the Islamic system, the provision of a positive high rate of return, although not requiring any arbitrary decision by the authorities to increase the nominal yield, would necessitate the mobilization of indigenous entrepreneurial ability through efficient project selection and the allocation of financial resources based on relative expected profitability of projects, rather the solvency creditworthiness or the collateral strength of the agent-entrepreneurs. If the bias against indigenous and small entrepreneurs persists and financial resources continue to flow to well-established and large entrepreneurs and/or the financial markets remain weak and shallow and asset choices limited, adoption of an Islamic financial system will not achieve its full potential in promoting economic development and growth.

## ENDNOTES

1. Ul-Haque (2000).
2. Ibid.
3. IRTI, Resolutions and Recommendations of The Council of the Islamic Fiqh Academy: 1985–2000, Islamic Development Bank, Jeddah, Saudi Arabia: 131.

## CHAPTER 7

# The Stability of the Islamic Financial System<sup>1</sup>

**T**he financial crisis that began in August 2007 is considered by many to be the worst since the Second World War. Representing the collapse of trillions of dollars of fictitious credit derivatives and the meltdown of uncontrolled credit growth, the scope of this crisis and its intensity have kept increasing and could potentially continue on a downward path for some time to come.

The crisis has crippled the financial system of many advanced countries, and has claimed as victims long-established banking institutions that were deemed “too big to fail.” Large bailouts by governments and massive liquidity injections by central banks may have served only to fan the flames. Capital markets have frozen and stock markets around the world have crashed, wiping out trillions of dollars in share value and in retirement investment accounts. The level of economic uncertainty is unprecedented over the last 80 years.

While the full impact of the crisis cannot yet be calculated, it has slowed down economic growth in many industrialized countries, increased unemployment to levels not seen in 25 years, triggered food riots and energy protests in many vulnerable countries, imposed extraordinary fiscal costs with unprecedented government bailouts and fiscal stimuli, and perhaps threatened the lives of more than 100 million people around the world. Notwithstanding its far-reaching and devastating consequences, the crisis has made the quest for financial stability a pressing and fundamental issue.

### **WHAT IS FINANCIAL STABILITY?**

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Financial instability has been a recurrent phenomenon in contemporary economic history, affecting countries to varying degrees and resulting in massive unemployment and lost economic output. The most enduring crisis was the Great Depression of 1929–33. Eminent economists who lived through

that period fought to establish a banking system capable of preserving long-term financial stability.<sup>2</sup> Although they were unaware of Islamic finance and its principles, their proposals were a natural restatement of some of the basic pillars of Islamic finance. The Chicago Plan basically divided the banking system into two components: (i) a warehousing component with a 100-percent reserve requirement, and (ii) an investment component with no money contracts and interest payments, where deposits are considered as equity shares and are remunerated with dividends, and maturities are fully observed. In the aftermath of the Chicago Plan and in the subsequent literature it has become clear that only a financial system along Islamic principles is immune to instability.

Financial stability is a basic concept in finance. It applies to households, firms, banks, governments, and countries. It is an accounting concept conveying notions of solvency, or equilibrium. For an entity, financial stability can be defined as a regular liquid treasury position, whereby the sources of funds exceed the uses of those funds. The sources of funds are diverse and include income streams (salaries, transfers, taxes, interest income, dividends, profits, and so on), borrowing or loan recovery, and sales of real and financial assets. The uses of funds include current expenditures (including interest and dividend payments, rents, salaries, taxes, and so on), capital expenditures, the purchase of assets, lending or debt amortization. Accounts are separated into income or current accounts, and balance sheet or capital accounts. Financial stability means that consolidated accounts are regularly in surplus.<sup>3</sup>

Financial instability can be defined as the opposite of financial stability. It can be associated with payment defaults, payment arrears, or insolvency. It manifests itself through a regularly deficient treasury position, whereby the sources of funds fall short of the uses of funds or payments obligations. When financial instability persists, access to borrowing becomes highly restricted. The entity facing financial instability may have to recapitalize, liquidate assets, restructure liabilities, seek a bailout or, in the extreme, may be subject to merger or liquidation.

### **The Role of the Credit Multiplier in Financial Instability**

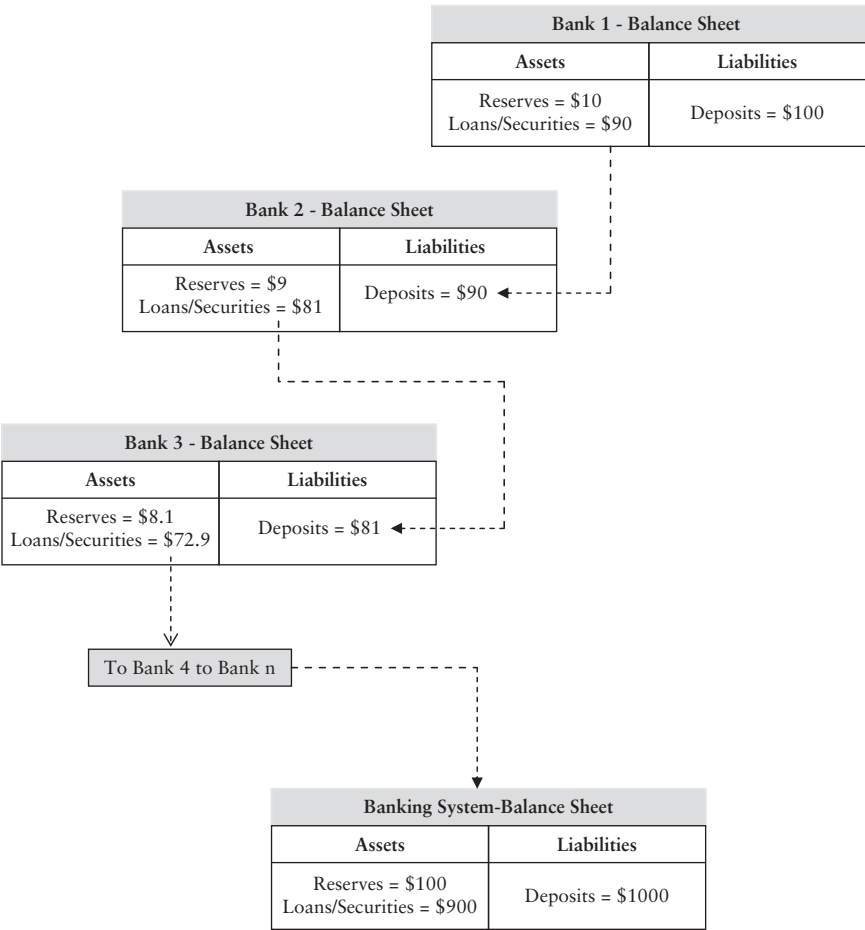
In banking, there is stability if the maturities of assets and liabilities are matched, assets preserve their values and do not depreciate, and the amount of IOUs is fully backed by gold or warehouse deposits that served for issuing these IOUs. Excessive issuance of gold or warehouse certificates, bank notes, or fiat money may cause instability as manifested in a run on the bank by domestic or international depositors.<sup>4</sup> The amount of claims may exceed the stock of gold or merchandise; under these conditions, conversion may be suspended, bankruptcies may occur, or IOUs may be devalued. Under a fiat money system, the central bank may act as the lender of last resort to preserve stability by printing new money, which in turn may lead to currency depreciation.

With the advent of the banking and credit system, the literature had noted during the eighteenth and nineteenth centuries that the amount of credit was a multiple of the quantity of gold in circulation. The development of bank deposits and checks as means of payment was considered by classical economists as an innovation that economized on the use of gold and expanded payments transactions without expanding the quantity of currency.<sup>5</sup> In a pure credit system, where all payments are carried out through debiting and crediting bank accounts, the economy could dispense with the use of currency altogether. Currency is issued by the state in the form of metallic money or notes. Bank notes and deposits are the money created by banks. The relationship between currency and bank deposits or credit is known as “the credit multiplier.”

Each bank can issue money, in the form of bank credit. Normally, banks issue credit against deposits. However, banks often issue a credit against insufficient deposits. Where there is a shortfall in liquidity, a bank borrows from other banks, issues papers, or borrows from the central bank. In a high-risk environment, banks may refuse to issue loans and prefer to accumulate excess reserves. The credit they issue depends on factors that act on the supply side (the banks) and the demand side (the borrowers). It also depends on the degree of development of the banking system. In countries where the banking system is not developed, credit plays a more limited role in the economy. In countries where the banking system is highly developed and the number of banks is large, credit tends to be a large component of the payments system.

In the money supply of any country, broad money, defined as currency in circulation plus demand and time deposits, is many times larger than high-powered money, or the monetary base. The money-creation process explains how depository banks create money (Tobin 1965). The creation of money is not a mechanical procedure; it depends on the bank's willingness to lend and the willingness of a borrower to borrow. If banks compete for loans, lower interest rates, and push credit to sub-prime borrowers, and borrowers are willing to accumulate debt, then credit may increase rapidly. By contrast, if the banks turn prudent and raise interest rates or borrowers face recession and falling profits, then money creation may contract. In conditions of prudent banking, banks accumulate excess reserves, and issue loans only to prime customers.

The mechanics of the credit multiplier are simple. Assume that the central bank buys a government bond worth \$100 by printing new money. The seller of the bond, be it government or a private holder, deposits the proceeds with Bank 1, thus increasing the bank's reserves by \$100 as shown in Figure 7.1. Assume that the reserve-requirement ratio is equal to 10 percent of deposits. The bank keeps \$10 dollars in reserves at the central bank, and places \$90 into income-earning assets such as loans or securities. The borrower of \$90 is paying interest. He will not keep this money idle at Bank 1. He will most likely use it to finance investment or purchase a car, or consumer goods. Therefore, the money will quickly leave Bank 1 and end up



**FIGURE 7.1** The credit multiplier process

as a deposit in Bank 2. The process of money creation through the credit multiplier continues until the initial amount of \$100 would have been multiplied by 10 to become \$1,000. The credit multiplier is thus defined as the inverse of the reserve-requirement ratio.

Two traditional sources of instability can be observed. First, assume a depositor at Bank 1 writes a check for \$100 to a beneficiary whose bank is Bank 3, and then Bank 1 finds it difficult to make the payment of \$100 and is caught with insufficient funds. If depositors at Banks 1 and 2 simultaneously exercise their drawing rights and write checks to a beneficiary at Bank 3, for amounts of \$100 and \$90, respectively, both Banks 1 and 2 will be caught short of funds. **Money creation at deposit banks leads, therefore, to an un-backed expansion of credit, which exceeds real savings in the**

**TABLE 7.1** Impact of credit and market risks

Balance Sheet: Bank 1	
Assets	Liabilities
Reserves = \$10	Deposits = \$100
Loans and securities = \$50	Central Bank Advance = \$40
Borrowed reserves = \$40	
Losses = \$40	
Total = \$140	Total = \$140

**economy.** The central bank plays a role as the lender of last resort. It will advance liquidity in the form of discounts to banks that are short of reserves for settling their liabilities. Central banks that fear financial instability may charge punitive rates for such loans.

A second source of instability may result from depreciations in the value of assets. Assume the loans and securities of Bank 1 depreciate to \$50 because of non-recoverable loans (credit risk), or a speculative fall in the prices of bonds, mortgage securities, foreign exchange, and other assets, (market risk), as illustrated in Table 7.1. Assume that a depositor at Bank 1 writes a check for \$100 for a payee at Bank 3, and then Bank 1 will be short by \$90. Besides liquidating its assets at discount, Bank 1 will have to borrow or inject new capital of \$40 to be able to meet its debt obligations. The banking system as a whole may face a general speculative depreciation of assets (stock market crashes, a fall in securities, bonds, or mortgage asset prices, non-performing loans, etcetera). The bailing out by the central bank will increase bank reserves and will lead to an expansion of the money supply. Such bailouts are inflationary and will impose a tax on money holders, creditors, wage earners and pensioners in favor of debtors. In other words, the central bank makes the public bear the cost of asset price depreciation, while asset price appreciation remains private and benefits speculators or asset holders.

## **FINANCIAL STABILITY OF ISLAMIC FINANCE**

As discussed in the previous chapter, theoretically, the Islamic financial system consists of a banking sector, a stock market, and a market for securitized assets. It was also shown that the banking sector may have a sub-sector which specializes in high-credit and short-maturity securities to finance trade or commodities on the basis of *murabahah* (cost-plus sale) to support the payment system. This would be analogous to the concept of narrow banking which has been suggested in the conventional system to promote stability in the payment systems and in the financial system.



Proponents of the Islamic system claim that a financial system based on the Islamic framework of risk sharing would be more efficient in allocating resources than a conventional interest-based system. This claim can be defended on the basis of the general proposition that any financial development that causes investment alternatives to be compared to one another based strictly on their productivity and rates of return is bound to produce improved allocations. Such a proposition is the cornerstone of the Islamic financial system. But would such a system also improve stability?

The general argument underlying the proposition that the Islamic financial system is more stable than the conventional system is based on three notions: (i) the avoidance of leverage and debt refinancing due to the prohibition of debt; (ii) the matching of assets and liabilities; and (iii) the elimination of the multiplier effect.

### **Absence of Leverage and Debt Refinancing**

Leverage is absent from the Islamic financial system because of the constrained debt-carrying power of economic units in the system and on the argument that the inability to refinance positions in assets by creating additional debt, along with the non-existence of interest rates, renders the system more stable.

In a conventional interest-based system, the financing of investments and the ownership of capital assets, as well as of consumer spending, is carried out primarily through borrowing and lending, whereby a structure of expected money receipts embodies the various commitments to make payments on existing debt. The liabilities on the books of an economic unit at any time are the result of past financing positions that are taken on the basis of various margins of safety, one of which is an excess of anticipated receipts over payment commitments. Based on this relationship, an economic unit in such a system can assume one of three financial postures.

First, a given economic unit in every period of its operation will have cash flows from its participation in income generation, which are expected to exceed contractual payments on outstanding debt. Another posture may place an economic unit in a position in which, in the short term, payment commitments exceed their corresponding cash flows, even though the total expected cash flows (totaled over the foreseeable future) exceed the total payments on outstanding debt and the net income position of the short-term cash flows exceeds the short-term interest payments on debts.

Finally, a situation may arise in which not only do the short-term payment commitments exceed the expected cash flows, but the short-term interest payments on outstanding debt also exceed the income components of the short-term cash flows. It has been argued that, in such an interest-based system, there is a tendency on the part of the economic units (consumers, firms, banks and governments) to increasingly assume the last two types of financial postures, in which economic units can fulfill their payment commitments on debt only by the borrowing or selling of assets. Since the appreciation

of an asset constitutes a portion of returns on that asset, the tendency is to refinance rather than sell assets. For refinancing, the amount that the second type of unit needs to borrow is less than the maturing debt of the third type of unit, and the latter will only be able to meet its payment commitments by increasing its outstanding debt.

The last two types of unit engage in speculative financing in the sense that they have to exchange short-term liabilities for long-term assets, thus speculating that, when the need arises to refinance and roll over, the refinancing of their maturing debts will be available at non-punitive interest rates. The viability of the third type of unit will rest on the assumption that some assets will be sold at high enough prices sometime in the future. Both the second and third types are vulnerable to interest-rate fluctuations, since these units finance a long position in assets by issuing short-term liabilities; hence, their viability depends on the price and the extent of the availability of refinancing. Their commitments provide for the repayment of debt at a faster rate than their net income will allow for the recapturing of the money costs of capital assets. Besides, there is a high probability of present value reversal for these units at higher interest rates, since higher interest rates lower the value of all cash receipts, but this decrease is proportionately greater for more-distant receipts. That is to say, a dated set of cash flows which yield a positive net present value (excess of asset values over the value of debts) at a lower interest rate may yield a negative excess at higher interest rates.

High and rapidly rising interest rates increase financing activities in which investment undertakings depend on an increase in total short-term debt outstanding. This is because the interest payments that are due on earlier borrowings exceed the income earned by the assets. As the short-term debt that leads to a capitalization of interest increases relative to the gross capital income, there is an increase in demand for short-term financing because of the need to refinance debt. This increased need to rely on maturing debt not only shifts the demand curve for short-term debt to the right but also makes the curve less elastic. If, in addition, the supply of short-term refinancing is also inelastic, the short-term interest rates can increase rapidly, which, in turn, leads to higher long-term rates and a lower value of capital assets.

Moreover, rising short-term interest rates, in conjunction with increasing long-term interest rates, not only reduce the demand for capital assets but also increase the cost of production of the output with a longer gestation period, thus leading to a decrease in investment. If the process of falling asset values, rising carrying costs for asset holdings, and decreasing profits increases the probability of illiquidity and insolvency for a significant number of firms and financial institutions, the participants in the market may not be willing to roll over or refinance the maturing debts of these institutions and a crisis will develop. It follows that for any given regime of financial institutions, the lesser the weight of debt refinancing, the greater the stability of the system.

### **Inherent Matching of Assets and Liabilities**

A bank in a conventional interest-based system is inherently exposed to asset and liability mismatches, which has been the source of instability in several financial crises in modern times. Such mismatches expose the banks to illiquidity, in the sense that their liabilities mature faster than their assets. To handle illiquidity the banks have three options. The first is to rely on the argument that the problem of liquidity is not so much a problem of maturity structure as one of shifting assets to other banks in exchange for cash. That is, if one bank can receive help from another bank when needed, there is no necessity to rely on maturing loans to provide liquidity; assets can be shifted to other banks before maturity as the need arises. The second option is for a bank to increase interest rates in order to attract greater deposits or maintain existing ones in times of difficulty, thus engaging in liability management to solve the problem of liquidity. If the short-term stock of total deposits is fixed within the banking system, these two alternatives can quickly spread the problem of illiquidity throughout the system. The danger that all banks can become illiquid, in the sense that their liabilities mature faster than their assets, cannot be met except via the third option, which is debt monetization; that is, the banks must sell their slow-maturing assets to the central bank in order to raise cash with which to meet fast-maturing liabilities. This option is not necessarily without cost. For one thing, once the banks resort to monetization, they may set in motion a vicious circle with its own momentum of acceleration.

An Islamic financial system can be expected to be more stable because of an inherent matching of assets and liabilities. First, the term and the structure of the assets and liabilities of the economic units are closely matched through profit-sharing arrangements. Second, the liabilities of each economic unit comprise equities and/or are fully amortized with an underlying future income flow. Third, the payment commitments of firms and financial institutions are, mostly, in the form of dividends that will have to be paid only if profits are received. Finally, no debt refinancing can take place on an interest basis; if there is any refinancing it must be on the basis of sharing of future income expected from assets. In an Islamic system, the danger of insolvency arises for economic units only if their revenues fall short of their out-of-pocket costs and commitments. Such a situation can only occur either as a result of poor management or extraneous economic factors, but it is not inherent in the financial system.

### **No Credit-multiplier Effect**

The stability of the Islamic banking system was investigated using a formal mathematical approach by Khan (1987), who demonstrated that the system may well turn out to be better suited for adjusting to shocks that result in banking crises and a disruption of a country's payments mechanism. Khan's model assumes an Islamic banking system structured in accordance with

the “two-windows” model discussed earlier. In the model, the banks accept deposits on the basis of profit and losses as if they were equity where the nominal value of shares is not guaranteed and the rate of return on which is variable. The model is shown to have stability in response to certain types of shocks. A major policy recommendation emanating from this study is that such a system, in which demand deposits have a 100-percent reserve requirement and investment deposits carry no guarantees, has desirable and inherent safety benefits.

Conceptually, Islamic finance is a two-tier system: (i) a 100-percent money system, and (ii) an investment banking system, modeled as an equity shareholding system.<sup>6</sup> Obviously, there is no money creation in a system with 100-percent reserve banking. Hence the credit multiplier is, by definition, zero for such a system. The investment banking accepts savings in the form of deposits and invests them in the purchase of equity shares. There is, therefore, no creation of money through credit, and investment is fully backed by savings. The amount of deposits in the investment branch will be determined by real savings and the savings-to-income ratio and not by the credit multiplier as in conventional banking. New cash flows to an Islamic investment bank originate from new savings, and not from the proceeds of loans transferred from one bank to the other. There is, therefore, a wealth-creating activity that generates new cash flows, and not money creation by the stroke of the pen as is the case in a conventional system. The process of savings and income generation can be described as follows: assume an Islamic investment bank accepts deposited savings in an amount of \$100. The bank invests this in the form of equity shares. Producing firms use this capital to buy machinery and raw materials, and to expand their production capacity. The recipients of the \$100, as a result of sales of their goods and services, are assumed to save, on average, a percentage of their income. For our purposes, we'll say 20 percent. Hence, they deposit new savings of \$20 at the Islamic investment bank. The latter purchases equity shares for \$20. Recipient firms invest the new capital. The recipients of the \$20, as proceeds of sales of their goods and services, will save, on average, 20 percent of their income, equivalent to \$4. It can be easily shown that the process of income and savings generation increases the initial \$100 of savings into \$125. If we assume an average savings ratio,  $s$ , then the savings multiplier is expressed as  $1/(1 - s)$ , and is directly proportional to the average savings ratio. The higher the savings ratio, the higher will be the accumulated savings.

The growth of financing activity will, therefore, be stable and determined by real growth in the economy, and not by unstable speculative finance or money creation by financial institutions. Accordingly, an Islamic system would not be expected to experience deep boom and bust cycles. Moderate and brief booms or recession may be generated by favorable climatic conditions or natural disasters, by productivity and technical change, or by real shocks. They cannot be generated by the financial system itself, as experienced and demonstrated under the conventional system. As shown in Mirakhor (1988), equilibrium in an Islamic economy thus structured will be

stable and the rate of return to the financial sector will be fully aligned with the profit rate in the real sector of the economy.

It is clear that if demand deposits are backed by a 100-percent reserve requirement, the run-associated features of fractional-reserve banking would be eliminated. By not imposing any reserve requirements for investment deposits and replacing the par conversion privilege with a net asset liquidation rule (for example, the rule that depositors bear the asset value risks on a pro rata basis), the incentive for runs on investment deposits would also be removed. The doctrinal justification for a 100-percent reserve requirement based on the property-rights argument was advanced in earlier chapters; the stability argument proposed is a further support for this view. Not all Muslim scholars, however, are convinced of the necessity of a 100-percent reserve requirement. The proponents of the two-tier *mudarabah* model argue that a fractional-reserve system fully guaranteed by a debt-issuance scheme coupled with careful project selection is sufficient to head off any potential run on the banks.

## CONCLUSION

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Classical economists recognized in their writings that banks create money. They also noted that business corporations, through issuing credit instruments such as bills of exchange, commercial papers and promissory notes, may contribute to an increase in quasi-money, when these instruments become monetized in the form of bank discounts or through endorsement. They identified the relationship between all forms of private credit instruments and circulating gold as the credit multiplier. The credit multiplier depends on the definition of money and quasi-money, on the degree of development of the credit system, and factors that motivate lenders to lend and borrowers to borrow. Cognizant of the money-creation power of banking and financial institutions, every country has adopted banking legislation and prudential regulation for limiting the use of this power beyond the norms of safety. The credit multiplier is inversely related to the reserve-requirement ratio in a fractional-reserve system. Under securitization and an asset-backed securities system, the credit multiplier is larger than under a reserve-requirement system and is theoretically unbounded. However, in practice, the abnormally inverted credit pyramid is bound to collapse when its underlying bubbles burst.

The credit multiplier was shown to be irrelevant for Islamic finance. The corresponding notion is a savings multiplier, which is directly proportional to the savings-to-income ratio. Islamic finance is theoretically immune from credit multiplication and the business fluctuations caused by credit booms and busts. The growth of financing activity will, therefore, be stable and determined by the real growth of the economy, and not by unstable speculative finance or money creation by financial institutions. Accordingly, an Islamic system would not be expected to experience deep boom and bust

cycles. Moderate and brief expansions and recession may be generated by good or bad crops, productivity and technical change, or by real shocks and not by the financial system itself. The general price level is stable and cannot be subjected to inflationary pressure. The rate of economic growth is stable and much higher than in a corresponding conventional finance system as Islamic investment banks finance only highly productive investment projects and not consumption, and are immune to the credit crises that characterize conventional finance.

Conventional banks fail to meet inherent stability conditions even in the presence of prudential regulations. First, credit losses from debt default or the depreciation of assets may create a large divergence in relation to liabilities that remain fixed in nominal value. Second, bank credit has no fixed relation to real capital in the economy and bears no direct relation to the real rate of return. Un-backed credit expansion through the credit multiplier and further leveraging is a fundamental feature of conventional banks. Cash flow could fall short of expectations and force large income losses on banks, especially when the cost of funds is fixed through a predetermined interest rate. Third, banks caught in a credit freeze, with a drying up of liquidity, may default on their payments. Fourth, banks are fully interconnected with each other through a complex debt structure; in particular, the assets of one bank instantaneously become liabilities of another, leading to fast credit multiplication. A credit crash causes a dramatic contagion and a domino effect that may impair even the soundest of banks.

Credit can be issued to finance consumption, and hence may rapidly deplete savings and investment. The depletion of savings could be significant if credit finances large fiscal deficits. Hence, credit is no longer directly related to the productive base, as it is in the equity-based system, and the income stream from credit is no longer secured by real output as shown for the equity system. Credit can expand through leverage to an unsustainable multiple of real national income, increasing the risk of default. Credit expansion through the credit multiplier is determined by the reserve-requirement system, whereas equity in the equity-based system cannot expand more than real savings. In the case of securitization, credit can, in theory, expand to an infinite degree.

In an economy governed by the principles of Islamic finance, the rate of return on equities is determined by the marginal efficiency of capital and time preference, and is positive in a growing economy. This implies that Islamic banks are always profitable provided that real economic growth is positive. This establishes a basic difference between Islamic banking, where profitability is fully secured by real economic growth, and conventional banking, where profitability is not driven primarily by the real sector and where banks may suffer losses even in the face of positive real growth. As we have seen, the Islamic banking system has two types of banking activity: deposit banking for safe keeping; and banking for payment purposes. This system operates on a 100-percent reserve requirement, and fees may be collected for this type of service. In this system, investment banking operates

on a risk/profit-sharing basis, with an overall rate of return which is positive and determined by the real economic growth rate. Islamic banks do not create and destroy money; consequently, the money multiplier, defined by the savings rate in the economy, is much lower in the Islamic system than in the conventional system, providing a basis for strong financial stability, greater price stability, and sustained economic growth.

Conventional banks issue debt and earn interest. Debt accommodation by banks has often been unlimited and has been checked only by crashes. We have shown that credit expansion may have no relation to the real capital base and no direct relation to the real cash flow in the economy that may be required for servicing debt. If financing were to be extended to consumption, then credit could erode the capital base and economic growth. The equilibrium interest rate that clears the money market may have no direct relation with the real rate of return in the economy. Such a deviation was acknowledged by the classical economists and was seen to be a cause of booms and busts, and excessive speculation in commodities and assets. Banks are obliged to pay the face value of their liabilities. In the case of credit loss, banks have to fully absorb these losses from their capital reserves or through recapitalization. Governments may be compelled to extend large and costly bailouts to rescue impaired banks and prevent a total collapse of the financial system.

The conventional system is vulnerable to many sources of instability. Besides the inability to reach full-employment output, the system can suffer from interest-rate distortions in relation to a natural interest rate and can suffer from the absence of a direct link to a real capital base that generates cash flow for servicing debt. Minsky (1986) described the conventional system as endogenously unstable, evolving from temporary stability to periods of crisis. Credit losses play havoc with the real economy and cause unemployment. The drying-up of credit during credit crashes makes the Modigliani-Miller theorem untenable. In such circumstances, leveraged firms will face higher financing costs for their investments or fluctuations in their operations. The issue of instability in conventional finance is not limited to the role of commercial and investment banks. In conventional finance, the central bank plays the critical role of lender of last resort. If it didn't do so, conventional banks—which are interrelated through loans—would risk simultaneous failure. Banks are exposed to credit and interest-rate risk and may run out of liquidity. In order to maintain their payments, the rediscount and borrowing from the central bank become pillars for the smooth functioning of conventional finance. In Islamic finance, banks do not have or cause any liquidity mismatch and are thus not dependent on central bank finance to maintain their liquidity.

Finally, we should note that the social and human costs of financial instability and financial crises, though impossible to quantify, might dwarf even the economic costs. The human cost of prolonged unemployment—its impact on the individual psyche and on families—cannot be overestimated. The impacts on individual regions are much more extreme than the average

effects. The unfair redistribution of wealth, at the expense of individuals on fixed incomes and creditors, is simply immoral. Islamic finance avoids these and other pitfalls of a financial system based on credit and leveraging. We cannot keep repeating the cycles of boom and bust and pretending that the next time the results will be different. We are living out the adage that defines stupidity as repeating the same act and expecting a different result the next time! It is time for the world community to lift its head out of the sand, to shed its reliance on debt, interest and leveraging, to totally revamp the financial system to rely on risk sharing.

## ENDNOTES

1. This chapter is based on research presented in Askari *et al.* (2010).
2. Their proposals became known as the Chicago Reform Plan; it was economics professors at the University of Chicago—Henry Simons, Frank Knight, Aaron Director, Garfield Cox, Lloyd Mints, Henry Schultz, Paul Douglas, and A. G. Hart—who elaborated the Plan. Professor Irving Fisher from Yale University was a strong supporter of the Plan. His book *100% Money* was an attempt to win support among academics and policymakers for the Plan.
3. The consolidated account can be compared to the overall fiscal account of the government or to the balance of payments of a country. Each account is composed of two components: a current account and a capital account. The overall balance of the consolidated account should be sustainable for financial stability to be maintained over time.
4. For instance, the United Kingdom suspended the Gold Standard in September 1931, following a run on its gold reserves. Similarly, the US suspended the gold standard in August 1971 when its gold reserves fell critically below the level of dollars held by foreign central banks that had the legal right to convert dollars into gold at the rate of \$35 per troy ounce of gold.
5. Bills of exchange, promissory notes, and commercial papers were issued in much larger amounts than circulating currency during the eighteenth and nineteenth centuries. They were also considered as instruments of credit that economize on the use of gold or bank notes. When discounted with banks, these credit instruments contribute to expand bank credit.
6. Deviation from this definition makes Islamic finance simply another form of conventional finance.



## CHAPTER 8

# Islamic Financial Intermediation and Banking

**F**inancial intermediaries are different from other economic agents. They not only channel resources from the capital surplus agents (generally, households) to capital deficit ones (the corporate sector), they also allow the inter-temporal smoothing of household consumption and business expenditures and thus allow both firms and households to share risks. Since the early 1980s, the increased complexity and volatility of the financial markets have led financial intermediaries to innovate and offer products to mitigate, transfer, and share financial risks.

The primary functions of a financial intermediary are asset transformation, conducting orderly payments, brokerage and risk transformation. Asset transformation takes place in the form of matching the demand and supply of financial assets and liabilities (for example, deposits, equity, credit, loans and insurance) and entails the transformation of maturity, scale and place of the financial assets and liabilities of the ultimate borrowers and lenders. The administrative function of an accounting and payments system (check transfer, electronic funds transfer, settlement, clearing) is considered another important intermediation function. Typically, financial intermediaries have also offered brokerage or match-making between the borrowers and lenders, and facilitated the demand and supply of non-tangible and contingent assets and liabilities, such as collaterals, guarantees, financial advice, and custodial services.

The nature of intermediation has changed drastically over the last four decades because of changes in macroeconomic policies, the liberalization of capital accounts, deregulation, advances in financial theory and technological breakthroughs. Financial intermediation in the form of traditional banking has declined considerably in developed countries, where market-based intermediation has become dominant. Traditional bank lending operations are being replaced by more fee-based services that bring investors and borrowers directly in contact with each other. Some degree of “dis-intermediation” has taken place due to the development of capital markets

which have changed the function of traditional financial intermediation. However, the complexity of markets in the wake of the financial crisis of 2007–09 has reignited the debate on the need for more intermediation.

Financial intermediation in Islamic history has an established historical record and has made significant contributions to economic development over time. Financiers in the early days of Islam were known as *sarrafs* and undertook many of the traditional and basic functions of a conventional financial institution such as intermediation between borrowers and lenders, operating a secure and reliable domestic and cross-border payment system and offering services such as the issuance of promissory notes and letters of credit. Commercial historians have equated the function of *sarrafs* with a bank. Historians like Udovitch considered them as “bankers without banks.” *Sarrafs* operated through an organized network and well-functioning markets, which established them as sophisticated intermediaries, given the tools and technology of their time. It is claimed that financial intermediaries in the early Islamic period instituted mutual-help arrangements to help one another overcome liquidity shortages. There is evidence that some of the concepts, contracts, practices, and institutions developed in the Islamic legal sources of the late eighth century provided the foundations for similar instruments in Europe several centuries later.<sup>1</sup>

In all the models for Islamic financial intermediation and banking described earlier, the core principle is that the Islamic bank operates as an agent of the investor (depositor) and both agree to share the profits and losses of investments made by the bank. Any losses incurred as a result of the bank’s investment activities are reflected in the depreciation of the value of the depositor’s wealth. All models see the probability of losses minimized through a diversification of the banks’ investment portfolios and careful project selection, monitoring, and control.

Financial intermediation can take several forms in Islamic financial markets. For the purposes of this chapter, we focus on financial intermediation either through deposit-taking Islamic banks or through “Islamic windows.”

## **FINANCIAL INTERMEDIATION BY ISLAMIC BANKS**

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An Islamic bank is typically a hybrid between a conventional commercial bank and an investment bank, and thus resembles a universal bank. Table 8.1 constructs a conceptual balance sheet of an Islamic bank based on different functions and services to give us an overview of its structure, operations and capabilities of intermediation.

### **Liabilities**

On its liabilities side, an Islamic bank offers current, savings, investment, and special investment accounts to its depositors. Unlike conventional commercial banks, which accept deposits with the promise to return the

**TABLE 8.1** A stylized balance sheet of an Islamic bank

Assets	Liabilities
Trade Financing ( <i>Salam, Murabahah</i> )	Demand Deposits ( <i>Amanah/Waad</i> )
Leasing / Rentals ( <i>Ijarah / Istisnah</i> )	Investment Accounts ( <i>Mudarabah</i> )
Profit/Loss Sharing Investments ( <i>Mudarabah</i> )	
Equity Investments ( <i>Musharakah</i> )	Special Investment Accounts ( <i>Mudarabah</i> )
Fee for Services	Capital Equity Reserves

principal amount in full and a predetermined return, an Islamic bank would not be able to offer such explicit guarantees of principal and fixed return but would have to assure depositors that it would select the best opportunities that minimize risk of any loss for the depositors but still provide attractive market-competitive returns. Using the techniques of portfolio management and diversification, an optimal portfolio of trade-related and asset-linked securities can be financed by the depositors' funds. By deploying the funds in this fashion, the intermediary will be able to not only offer short-term time deposits with minimized financial risk and sufficient liquidity, but will also facilitate a system-wide payment system that is backed by real assets.

**Current accounts** are demand accounts kept with the bank on custodial arrangements and are repayable in full on demand. Current accounts are based on the principle of *wadia* (trust or safe keeping) or *amanah* (trust), creating an agency contract for the purpose of protecting and safekeeping the depositor's assets. The major portion of the bank's financial liabilities would consist of **investment accounts** that are, strictly speaking, not liabilities but a form of equity investment, generally based on the principle of *mudarabah*. Investment accounts are offered in different forms, often linked to a pre-agreed period of maturity, which may be from one month upwards and could be withdrawn if advance notice is given to the bank. The profits and returns are distributed between the depositors and the bank, according

to a predetermined ratio (typically 80:20 but may vary considerably from bank to bank).

A bank may also offer **special investment accounts** customized for the investors, who may be ordinary householders, high-net-worth individuals or institutional clients. These accounts also operate on the principle of *mudharabah*, but the modes of investment of the funds and distribution of the profits are customized to suit the needs of the clients. In general, these accounts are linked to special investment opportunities identified by the bank. These opportunities have a specific size and maturity and result from the bank's participation in a pool of investment, private equity, joint venture or a fund. To some extent these accounts resemble specialized funds to finance different asset classes. The maturity and the distribution of profits for special investment accounts are negotiated separately for each account, with the yield directly related to the success of the particular investment project. Special investment accounts have considerable potential for designing and developing funds with specific risk–return profiles to offer customers and clients opportunities to manage portfolios and to perform risk management. In addition to deposits, an Islamic bank offers basic banking services such as fund transfers, letters of credit, foreign exchange transactions, and investment management and advice, for a fee, to retail and institutional clients.

The last item on the liabilities side is, typically, equity capital and reserves accumulated over the time. It should be noted that given the prohibition of debt, Islamic banks do not carry any debt capital, which could be a significant source of capital for the conventional banks. Rather, they are capitalized through equity. It has been argued that since the mode of intermediation is based on the profit/loss-sharing agreement which is a “pass-through” system, Islamic banks do not need to keep significant equity capital. This notion may be theoretically correct but as we will see later Islamic banks are still required to maintain a certain minimum level of capital. They can also set aside a portion of the profits each year as reserves to be used during times of economic slowdown.

Table 8.2 shows the major liabilities of a typical Islamic bank broken into sub-categories used for reporting purposes.

## Assets

While the liabilities side of the bank has limited modes of raising funds, the assets side can carry a more diversified portfolio of heterogeneous asset classes, representing a wider spectrum of risk and maturity profile. For short-term maturity, limited-risk investments, there is a choice of investing in short-term trade financing. Such assets originate from trade-related activities, such as *murabahah*, *bay' al-muajjil*, or *bay' salam*, and are arranged by the bank, which uses its skills, market knowledge and customer base to finance the trading activity. In addition, the bank can provide short-term funds to its clients to meet their working capital needs. The short-term maturity of these instruments and the fact that they are backed by real assets minimize their

**TABLE 8.2** Liabilities reported on financial statement**Liabilities**


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Customers' Funds
Current & Savings Demand Deposit Accounts
<i>Mudarabah</i> Investment Accounts
<i>Mudarabah</i> Savings Accounts
Other (customer accounts, special <i>Mudarabah</i> accounts, etc.)
Funds Due To Other Creditors
Funds Due To Other Creditors
Due to Banks and other Financial Institutions
Due to Subsidiaries and Associated Companies
Margins on LCs and Accounts Payable
Due to Employees, Contractors and Suppliers
Profit and Other Liabilities
Profit/Dividend Payable
Provision for Taxes and <i>Zakah</i>
Other Liabilities
Reserves
Shareholders' Equity

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level of risk. The bank considers these securities highly attractive and gives them preference over other investment vehicles.

For medium-term maturity investments, the bank has several choices. The funds can be invested in *ijarah* and *istisna'*-based assets. A benefit of these contracts is not only that they are backed by an asset, but that they can also have either a fixed or a floating-rate feature that can facilitate portfolio management. The common features of Islamic and conventional leasing provide additional investment opportunities for the bank since investing in conventional leases with appropriate modifications can be made consistent with *Shari'ah* principles. However, leasing has its own overheads, which a bank may not like to accept. For example, leasing requires a bank to deviate from its primary role as a financial intermediary, in that it involves purchasing an asset and retaining ownership of it until the asset is disposed of, with the responsibility of maintenance and associated costs over the life of the contract. Disposing of the asset requires not only bearing all risks resulting from price fluctuations, but also some marketing expertise. All this will require the bank to engage in activities beyond financial intermediation.

In addition, an Islamic bank can set up special-purpose (customized) portfolios to invest in a particular asset class and sector and can finance these portfolios by issuing special-purpose *mudarabah* investment accounts. In some way, this segment of the assets side represents a "fund of funds," where each fund is financed by matching *mudarabah* contracts on the liabilities side

through special investment accounts. For longer-term maturity investments, an Islamic bank can engage in venture capital or private equity activities in the form of *musharakah*.

An Islamic bank can attract depositors/investors either by inviting them to share profits and losses on a general pool of assets maintained by the financial intermediary itself, or by acting as a dealer/broker for third-party products. The general pool could be in the form of various funds specializing in specific sectors or geographical regions. In this case, the investor/depositor will be placing funds with the bank in a fund of funds, which would be a collection of diversified portfolios of financial assets. The relationship between the bank and the depositors/investors could be on the basis of either a *mudarabah*, where the bank manages assets for a fee, or a *musharakah* (equity partnership), where the bank shares profits and losses with the depositors/investors. In either case, there is risk sharing between the financial intermediary and the depositor/investors.

On the other hand, the Islamic bank can simply act as dealer/broker and help the investor in selecting and placing funds in portfolios of independent fund managers who specialize in specific asset classes, investment styles, sectors, and maturity terms. In this case, the bank facilitates the purchase/sale of third-party products and has no liability regarding the outcome or the performance of those products. However, the bank may perform due diligence on the fund and its managers before making any recommendations to its customers.

Table 8.3 shows broad and detailed classifications of the assets side of a typical Islamic bank for financial reporting purposes. Typically, the assets are divided into banking and trading books. The banking book consists of old-fashioned investments and financing of real sector activities, whereas the trading book contains financial securities such as bonds.

## **SOURCES AND USES OF FUNDS**

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Table 8.4 shows how an Islamic bank raises funds (the sources) and how these funds are utilized (applied) through investments. The sources of funds are also the liabilities of the bank. When compared to a conventional bank, Islamic banks do not use debt as the source of funding, which prevents them from indulging in or creating leverage. With the exception of demand deposits, all the sources of funds are directly linked to the financing of assets and there is no disconnect between the sources and the application of funds. Whereas conventional banks tend to use the funds by investing heavily in debt securities (treasury bills and notes), Islamic banks use the funds to provide direct funding of real economic activities—an important function which has been fading from modern conventional banks.

As described in Chapter 6, the Islamic financial system proposes a capital market consisting of equity markets and securitized asset-linked securities. Islamic banks and financial intermediaries can serve three functions in

**TABLE 8.3** Major assets on financial statements**Assets**

## i. Cash and its Equivalents

Cash in vaults

Cash with central bank

Balances with banks and other institutions

Cash equivalents

## ii. Financing using Islamic Modes

*Qard-ul-hassan**Murabahah* and deferred sales

Leasing and hire purchase

*Mudarabah**Musharakah**Salam**Istisna'*

Others

Less provisions

## iii. Portfolio Investments

Investment in companies, funds, shares

Investment in *Shari'ah*-compliant bonds, bills, securities

Investment in properties and real estate

Other investments

Less provisions

## Other Assets

Prepaid expenses and other receivables (net)

Real estate and properties owned (net)

Fixed assets net of depreciation

Other assets (net)

**TABLE 8.4** Sources and application of funds

Sources (liabilities and equity)	Application (assets)
Equity capital and shareholders' reserves	Short-term trade finance ( <i>murabahah</i> , <i>salam</i> )
Demand and safekeeping deposits ( <i>amanah</i> )	Regulatory cash-reserve requirement Medium-term investment ( <i>ijarah</i> , <i>istisna'</i> )
Investment accounts ( <i>mudarabah</i> ) "pass-through"	Long-term partnerships ( <i>musharakah</i> )
Special investment accounts ( <i>mudarabah</i> , <i>musharakah</i> )	Fee-based services ( <i>jo'alah</i> , <i>kifala</i> , and so forth)

Source: van Greuning and Iqbal (2008)

a securitized market. First, as “originator” of the assets, they can become the main and constant source of assets for the securitized market. In this way, Islamic banks become the supplier of the assets to the securitized market and then replace those assets with new assets. Second, similar to a conventional investment bank, Islamic banks can perform the important function of underwriting the asset-linked securities and also act as broker or dealer. Third, they can build a portfolio of asset-linked securities on their assets side. By keeping “asset-linked” securities on the assets, Islamic banks thus benefit from the liquidity of assets and the ability to buy and sell securities at market prices, which enable them to perform better portfolio management.

Table 8.5 shows different functional components of an Islamic bank from maturity and risk perspectives to show that an Islamic bank as a financial intermediary is able to offer the full spectrum of commercial and investment banking services in an efficient fashion. There is sufficient diversity on both the asset and liability sides to undertake all critical functions expected from an efficient financial intermediary.

## **DISTINCTIVE FEATURES OF THE ISLAMIC MODE OF INTERMEDIATION AND BANKING**

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Financial intermediation and banking differs from conventional banking in several ways. These are set out below.

### **Nature of Fiduciary Responsibilities**

The agency theory has generated considerable interest in financial economics, including Islamic banking. In an agency relationship, one party (the principal) contracts with another party (the agent) to perform some actions on the principal's behalf, and the agent has the decision-making authority. Agency relationships are ubiquitous: for example, agency relationships exist among firms and their employees, banks and borrowers, and shareholders and managers. Jensen and Meckling (1976) developed the agency model of the firm to demonstrate that a principal-agent problem (or agency conflict) is embedded in the modern corporation because the decision-making and risk-bearing functions of the firm are carried out by different individuals. They noted that managers have a tendency to engage in excessive perquisite consumption and other opportunistic behavior because they receive the full benefit from these acts but bear less than the full share of the costs to the firm. The authors termed this “the agency cost of equity,” and pointed out that it could be mitigated by increasing the manager's stake in the ownership of the firm. In the principal-agent approach, this is modeled as the incentive-compatibility constraint for the agent, and an important insight from this literature is that forcing managers to bear more of the wealth consequences of their actions is a better contract for the shareholders.



**TABLE 8.5** Functional components of an Islamic financial intermediary

Assets	Liabilities
Cash	Demand deposits
100-percent reserves	( <i>amanah</i> )
<b>Trade Finance Portfolio</b>	Short-term investment deposits
Term: short-term	( <i>mudarabah</i> )
Risk level: very low	
Instruments: <i>mudarabah</i> , <i>bay'salam</i>	
<b>Portfolio of Consumer and Corporate Assets Financing</b>	Restricted Investment deposits for varying maturities
Term: short- and medium-term	( <i>mudarabah</i> )
Risk level: low	
Instruments: <i>ijarah</i> , <i>istisna'</i> mortgages	
<b>Syndicated Investment Portfolio</b>	Restricted and unrestricted investment deposits.
Term: Medium- to long-term	( <i>mudarabah</i> )
Risk level: moderate to high	
Instruments: <i>mudarabah</i> , <i>musharakah</i>	
<b>Fund Management</b>	Wealth Management
<b>Private Equity</b>	( <i>mudarabah</i> , <i>wikala</i> , <i>musharakah</i> )
<b>Joint Venture</b>	
Term: Long-term	
Risk level: High	
Instruments: <i>mudarabah</i> , <i>musharakah</i>	
<b>Fund of Funds</b>	Investments through deposits or through tradable securities
Diversified portfolios specializing in market securities and investments in asset-linked securities of various risk and maturity profiles	( <i>mudarabah</i> , <i>musharakah</i> )
<b>Fee-generating Activities</b>	
<b>Underwriting</b>	
<b>Asset Management</b>	
<b>Research</b>	
	Equity capital ( <i>musharakah</i> )
	Reserves

Applying the agency theory to profit/loss-sharing instruments such as *mudarabah* has been modeled by Haque and Mirakhor (1989) and Presley and Session (1994). These models found that under a *mudarabah* profit/loss-sharing contract, it is the managerial effort which picks up the role of policing the contract. A standard incentive-compatible interest-based contract

creates an explicit mapping between the input and remuneration of capital, so that the manager is left free to choose the individually optimal level of effort in each state contingent on the specified level of investment. However, in the case of a *mudarabah*, an explicit mapping between the remuneration of capital and the outcome of the project is created. A *mudarabah*, therefore, allows the contract to control directly the manager's incentive to exert effort, since this effort affects the relationship between capital investment and the outcome of the project. Under a *mudarabah* contract, the manager is free to choose the individually optimal level of investment in each state of the economy contingent on his contractually specified level of effort. Presley and Session's model concludes that these individually optimal levels correspond to the full-information, productively efficient levels such that a mean variance improvement in capital investment is obtained—that is, average investment is increased whilst inefficiently large fluctuations around this level are reduced.

With financial intermediation in Islam, the intermediary simply “passes through” the performance of its assets to the investors/depositors on its liability side. There is an element of risk sharing present in the contractual agreement between the financial intermediary and the depositors/investors. The assets on the asset side of the balance sheet could be in the form of over-the-counter assets financed by the Islamic bank or direct investments in marketable securities of *Shari'ah*-compliant assets; that is, equities or asset-linked securities. Table 8.6 describes the contractual roles of an Islamic financial intermediary (IFI). For Islamic banks, there is a greater diversity of contractual agreements as the bank may be acting as a trustee in one mode of intermediation and as a “partner” in another. The bank also enters into a principal/agent model on both sides of the balance sheet. The purpose of showing different contractual agreements is to show that Islamic banks have more fiduciary responsibilities which have a direct impact on the governance of the financial institution.

### **Profit/Loss Sharing**

The profit/loss-sharing concept implies a direct concern for the profitability of the physical investment on the part of the creditor (the Islamic bank). The conventional bank is also concerned about the profitability of the project, because of concerns about potential default on the loan. However, the conventional bank puts the emphasis on receiving the interest payments according to set time intervals, and so long as this condition is met, the bank's own profitability is not directly affected by whether the project has a particularly high or a rather low rate of return. In contrast, the Islamic bank has to focus on the return on the physical investment, because its own profitability is directly linked to the real rate of return.

The direct links between the payment to the creditor and the profitability of the investment project is of considerable importance to the entrepreneur. Most importantly, profit-sharing contracts have superior properties in the

**TABLE 8.6** Contractual roles of an IFI and a conventional bank compared

	Contract	Contractual role of IFIs		
		Trustee	Partnership	Principal/ agent
	Link to conventional finance	Agency/ brokerage	Investment banking	Conventional/ commercial banking
<b>Liabilities—funding sources</b>				
Demand deposits	<i>Amana</i> (Trust)	✓		
Investment accounts	<i>Mudarabah</i>			✓
Special-investment accounts	<i>Mudarabah</i>			✓
	<i>Musharakah</i> (Partnership)		✓	
Equity—shareholders’ funds	<i>Musharakah</i> (Partnership)		✓	
<b>Assets—application of funds</b>				
<b>Transaction contracts</b>				
<b>Short-term trade financing</b>				
	<i>Murabahah</i>			✓
	<i>Bay’ al-salam</i>			✓
	<i>Bay’ al-muajjal</i>			✓
<b>Medium-term investments</b>				
	<i>Ijarah, Istisna’</i>		✓	✓
	<i>Mudarabah,</i> <i>Musharakah</i>		✓	✓
<b>Long-term partnerships</b>				
	<i>Mudarabah,</i> <i>Musharakah</i>		✓	
			✓	
<b>Fee-based services</b>				
	<i>Jo’alah, Kifala, etc.</i>	✓	✓	✓

Source: van Greuning and Iqbal (2007)

area of risk management, because the payment the entrepreneur has to make to the creditor is reduced in periods of economic downturn. Also, if the entrepreneur experiences temporary debt-servicing difficulties in the interest-based system, for example, on account of a short-term adverse demand shock, there is the risk of a magnification effect; that is, credit channels might dry up because of lenders overreacting to the bad news. This is due to the fact that the bank's own profitability is not affected by the fluctuating fortunes of the client's investment, except when there is a regime change from regular interest payments to a default problem. In other words, interest payments are due irrespective of the profitability of the physical investment, and the conventional bank experiences a change in its fortunes only when there are debt-servicing difficulties. However, a temporary cash-flow problem for the entrepreneur and just a few delayed payments might be seen to be a regime change, which could blow up into a "sudden stop" in lending. In the Islamic model, these temporary shocks would generate a different response from the bank, because the lenders receive information on the ups and downs of the client's business regularly in order to calculate their share of the profits, which provides the important advantage that the flow of information, as indeed the payment from the borrower to the lender, is more or less on an ongoing basis.

### **Enhanced Monitoring**

Islamic financial contracting encourages banks to focus on the long term in their relationships with their clients. However, this focus on long-term relationships in profit/loss-sharing arrangements means that there might be higher costs in some areas, particularly with regard to the need for monitoring the performance of the entrepreneur. Conventional banks are not obliged to oversee projects as closely as Islamic banks, because the former do not act as if they were partners in the physical investment. To the extent that Islamic banks provide something akin to equity financing as against debt financing, they need to invest more in managerial skills and expertise in overseeing different investment projects. This is one reason why there is a tendency amongst Islamic banks to rely on financial instruments that are acceptable under Islamic principles but may not have the best risk-sharing properties, because in some respects they are closer to debt than to equity.

### **Asset/Liability Management**

Theoretically, Islamic banks offer their asset portfolios in the form of risky open-ended "mutual funds" to investors/depositors. By contrast, banks in the conventional system finance the assets through issuing time-bound deposit contracts. This practice results in solvency and liquidity risks, since their asset portfolios and loans entail risky payoffs and/or liquidation costs prior to maturity, while their deposit contracts are liabilities that are often payable instantly at par. In contrast, Islamic banks act as agents for investors/depositors and therefore create a pass-through intermediation between

savers and entrepreneurs, eliminating the risks faced by their conventional counterparts.

One of the most critical and distinguishing features of financial intermediation by Islamic banks is the inherent design by which the assets and liabilities sides of the Islamic bank's balance sheet are matched. In a conventional bank, deposits are accepted at a predetermined rate, irrespective of the rate of return earned on the bank's assets side. This instantaneously creates a fixed liability without any certainty that the bank will be able to earn more than it promised or was committed to paying to the depositors. Since the return on the asset depends on the bank's ability to invest the funds at a higher rate than the one promised on the liability side and this rate is unknown, it can lead to the classical problem of mismatch between assets and liabilities.<sup>2</sup>

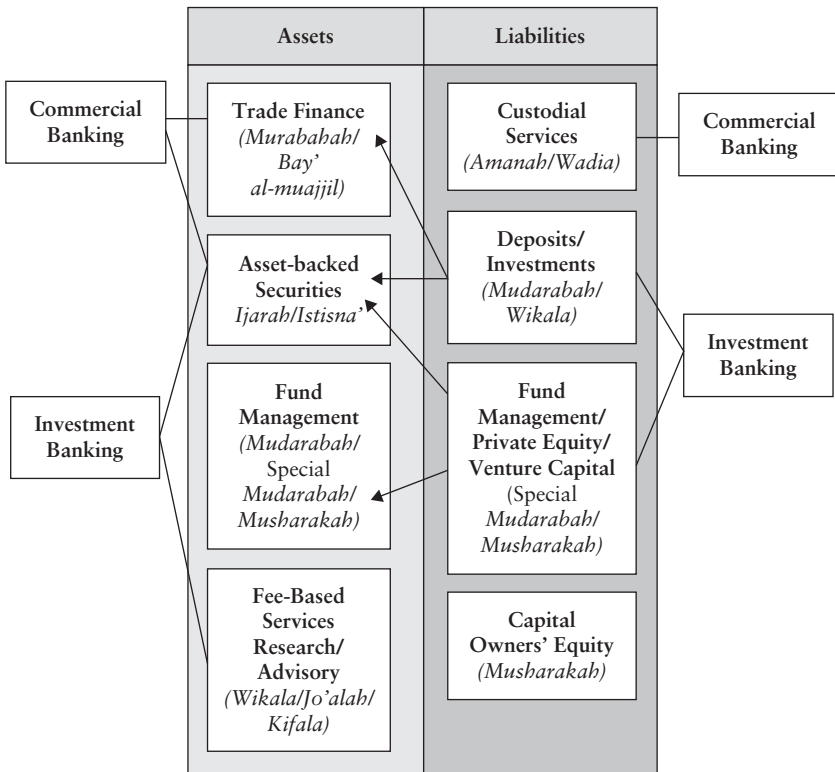
Since there is no such predetermined rate on the assets side of the Islamic bank, the asset–liability mismatch does not arise. It has been argued that because of the pass-through nature of the business and the close matching of assets and liabilities, financial intermediation by Islamic banks contributes to the stability of the financial system.

### **Universal Banking**

It is also interesting to note that the structure of a hypothetical Islamic bank or financial intermediary combines the activities of commercial and investment banking, as shown by the boxes on either side of the balance sheet in Figure 8.1. Here, each box on the assets and liabilities sides represents a specialized function or financial service, whereas the arrows across liabilities and assets indicate how assets and liabilities can be matched. Each box can also help us understand the separation of assets and liabilities based on their function, risk profile, maturity structure and the targeted market. Similar to a conventional commercial bank, such a financial intermediary can raise funds as deposits and invest them in low-risk, high-quality, investment-grade trade financing or asset-backed securities. Like an investment bank, it can offer underwriting services, asset management through specialized *mudarabah* funds and other advisory services such as research about financial markets, the maintenance of benchmarks, portfolio management, and risk management.

### **Shari'ah Boards**

One of the distinctive features of Islamic banking is the existence of a *Shari'ah* board that comprises religious scholars and the influence this board exerts on the operations of the bank. Islamic banks cannot introduce a new product without the prior permission and approval of their *Shari'ah* board and, depending on the affiliation of the religious scholars on the board to any particular school of jurisprudence, this can determine the success or failure of a product with its target clients. A shortage of *Shari'ah* scholars well



**FIGURE 8.1** Conceptual balance sheet of an IFI

versed in both *Shari'ah* matters and modern banking, means that many of these scholars sit on a number of boards, so that each institution may claim strong endorsement to enhance the credibility of its practices. The existence of *Shari'ah* boards provides satisfaction to the depositors that the board is monitoring the institution's compliance with *Shari'ah* principles.

Table 8.7 shows the actual balance sheet of the Dubai Islamic Bank as of December 2009. On the liabilities side, customers' deposits are the main liabilities and there is no breakdown of types of deposits. On the assets side, there are four major assets. Of course, Islamic investments are the biggest contributor but there is no information on what mode of investment is used. After investments, cash reserves with the central bank are significant. The reason for keeping large cash reserves is that there is a lack of liquid investment vehicles available to Islamic banks. In addition, after the financial crisis, several financial institutions raised their cash reserves to show ample liquidity and to send a signal to their customers that their liquidity needs can be met easily. The third-largest category of assets is *sukuk* (Islamic bonds), investments which are part of the trading book. There is also noticeable size of real estate and property investments.

### THE ROLES AND FUNCTIONS OF THE FINANCIAL INTERMEDIARY ARE SUMMARIZED BELOW.

- The distinction of the depositor is limited to demand deposits, while the depositor is treated as an investor for all other type of deposits.
- The depositor/investor can interact with the financial intermediary as principal/agent, directing the financial intermediary to invest funds for a fee, or can become a partner with the financial intermediary in sharing risks and, therefore, profits and losses.
- The financial intermediary can perform capital mobilization through direct financing or through the underwriting of marketable securities. The financial intermediary can construct diversified portfolios of assets with varying risks and maturities to match the depositors/investors' investment objectives.
- Given the basic building blocks of intermediation, an optimal and efficient intermediation can be implemented with a full spectrum of commercial- and investment-banking activities. Given this, we can say that intermediation resembles universal banking, with the major difference being that even the commercial banking is conducted on a risk-sharing basis and investment banking is encouraged.

**TABLE 8.7** Dubai Islamic Bank: Balance sheet, December 2009

Dubai Islamic Bank	
Annual Report as of Dec. 31, 2009	
Assets	AED'000
Cash and balances with Central Banks	11,611,570
Balances and deposits with banks and other financial institutions	1,352,299
International murabaha with financial institutions, short term	1,204,959
Islamic financing and investing assets, net	49,924,941
Investments in Islamic <i>sukuk</i>	9,290,797
Investments in associates	4,295,168
Other investments	1,925,950
Properties under construction	388,648
Properties held for sale	157,269
Investment properties	1,996,288

Receivables and other assets	1,464,071
Property, plant and equipment	657,795
Goodwill	34,516
<b>Total assets</b>	<b>84,304,271</b>
<b>LIABILITIES</b>	
Customers' deposits	64,195,503
Due to banks and other financial institutions	1,449,051
<i>Sukuk</i> financing instruments	2,415,034
Medium-term <i>wakalah</i> finance	3,752,543
Other liabilities	3,370,804
Accrued <i>zakat</i>	140,536
<b>Total liabilities</b>	<b>75,323,471</b>
<b>EQUITY</b>	
Share capital	3,617,505
Treasury shares	(70,901)
Statutory reserve	2,731,879
Donated land reserve	276,139
General reserve	2,350,000
Exchange translation reserve	(77,841)
Cumulative changes in fair value	(723,713)
Hedging reserve	50,600
Retained earnings	822,222
Equity attributable to equity holders of the Parent	8,975,890
Non-controlling interest	4,910
<b>Total equity</b>	<b>8,980,800</b>
<b>Total liabilities and equity</b>	<b>84,304,271</b>
Contingent liabilities and commitments	25,638,030

### Other Forms of Intermediation

Whereas early forms of Islamic financial institutions focused on commercial banking activities, more diverse forms have emerged in the last two decades to cater to the demands of different segments of the market. Although the Islamic mode of banking has been mandated and adopted by the Islamic Republics of Iran, Pakistan and Sudan, the supply of *Shari'ah*-compliant products has been primarily led by the private sector. In the Islamic Republic of Sudan, however, the State has actively promoted the introduction of new modes of financing.



In fact, private Islamic banks as a group are becoming some of the largest private-sector financial institutions, with growing networks through branches and/or subsidiaries within the Islamic world. While there is no standard way of grouping Islamic financial institutions, they can be divided into the following broad categories according to the services they offer:

- Islamic windows
- Islamic investment banks and funds
- Islamic mortgage companies
- *Mudarabah* companies.

As we saw in Chapter 1, Islamic windows are not independent financial institutions, but are specialized set-ups within conventional financial institutions that offer *Shari'ah*-compliant products for their clients.

In the 1980s, the dearth of quality investment opportunities within Islamic banks created business opportunities for conventional Western banks to act on their behalf in placing funds in commerce and trade-related activities, by arranging for a trader to buy goods on behalf of the Islamic bank and to resell them at a mark-up. Gradually, Western banks began to offer Islamic products of their own and, given the growing demand for *Shari'ah*-compliant products, non-Western conventional banks also started offering Islamic windows targeting high-net-worth individuals who wanted to practice Islamic banking.

## **ISLAMIC BANKING: THEORY VS. PRACTICE**

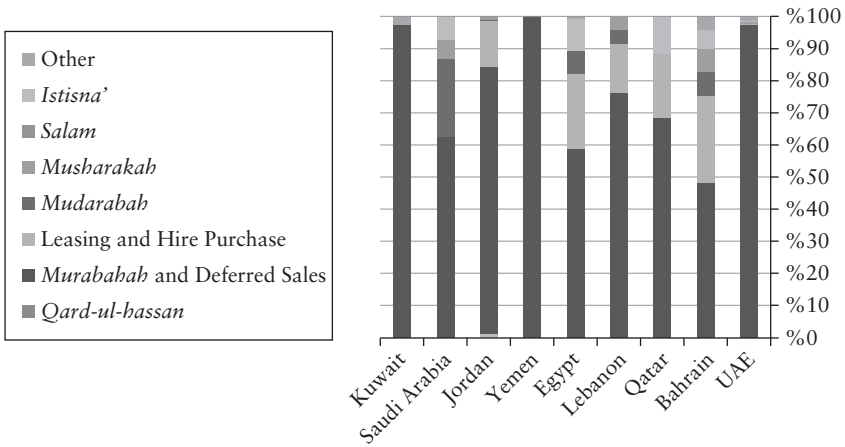
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The structure and current practices of Islamic banks differ in several respects from the theoretical models discussed in the previous chapter. Some of these differences are the obstacles faced in the full implementation of an Islamic financial system. These factors not only affect the further evolution of the industry, but also pose challenges to the regulators. The following are the highlights of the main divergences between the theory and the practice.

### **Under-utilization of Risk-sharing Contracts**

The first difference is the significant deviation of the structure of assets from what the theory prescribes. On the assets side of the balance sheet, as expected, a clear preference for asset-backed securities (based on trade finance) is evident, as opposed to partnership-based instruments requiring the sharing of profits and losses. This preference arises from the fact that sales-related securities are considered low risk and resemble familiar conventional fixed-income securities in their risk–return profile.

Islamic banks have not utilized partnership-based instruments, such as *mudarabah* and *musharakah*, on their assets side because of the high monitoring costs associated with these instruments resulting from asymmetrical



**FIGURE 8.2** Composition of assets of Islamic banks, 2008

Source: Middle East Flagship Report (2010)

information and moral hazard. The banks are not willing to allocate their limited resources for monitoring purposes. In addition, the market for partnership-based financing requires a well-functioning infrastructure where information about potential entrepreneurs and their projects is readily available, and the majority of markets where Islamic banks are correctly operating lack such sophisticated infrastructure.

Figure 8.2 shows the composition of various modes of financing across different countries for 2008. The bulk of the financing is undertaken in the form of trade financing activities and, contrary to the partnership-based financing the system promotes, equity-based assets are seriously lagging behind. Heavy reliance on trade financing is often referred to by critics as “*mudarabah* syndrome” and is not considered as a positive feature. In addition to trade-based instruments, Islamic banks prefer leasing, which is considered to have less-uncertain returns than the partnership-based *musharakah* or *mudarabah*.

### Separation of Investor Classes

Another aspect of the divergence between the practice and the theory is the choice and application of accounting policies that affect the allocation of income between shareholders and account holders or between different classes of account holders. In theory, Islamic finance has clear barriers in the deployment of assets between those funded by demand deposits, general investment accounts, special investment accounts and equity. However, current practice does not include such barriers, with the asset side treated as one large bucket with all stakeholders’ funds mixed together. In its functions, an Islamic bank is a hybrid of both a commercial and an investment bank,

and more akin to a universal bank. However, unlike conventional universal banks, Islamic banks do not erect firewalls to separate, legally, financially and managerially, their investment and commercial banking services. As a result, funds in investment accounts are not “ring-fenced” from the funds of others, including the equity holders. This is one of the most critical deviations in the practice of Islamic banks and one that poses a tough challenge to regulators because different stakeholders need to be regulated under different regulating principles and therefore taking a one-size-fits-all approach becomes restrictive and may defeat the whole objective of regulation in this case. This is further elaborated and discussed in the chapter on the regulation of Islamic financial institutions.

### **Investors’ Rights and Governance**

Another divergence between principle and practice, related somewhat to the foregoing issues, is the status of the investment accounts. Although they are supposed to be operating on profit and loss principles, actual practice differs. IFIs have faced criticism when they write down the value of assets, because they do not in practice write down the value of deposits. This implies that losses on the asset side are absorbed by either other deposit holders or by the equity holders. This practice raises a question on their degree of transparency and information disclosure. It also raises the issue of the need to separate asset types to match them closely to liabilities, either through firewalling or through segmentation.

This deviation leads to the question of the governance rights of the investment account holders. Large investment accounts serve as sources of capital to finance pools of investments and assets of the financial institution, but their holders are not granted any participation in the governance or monitoring process. The majority of investment account holders are individuals who may not organize themselves collectively to perform the necessary monitoring. Under such circumstances, the responsibility of the regulators and the *Shari’ah* boards increases further, to ensure that adequate monitoring mechanisms are in place to protect the rights of the investment account holders.

## **CRITICAL ISSUES WITH CURRENT PRACTICE**

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### **Illiquidity**

Predominantly, the transactions on the assets side of Islamic banks consist of customized or tailor-made transactions between the bank and its client. There is no organized market to securitize the bank’s assets and to trade the securities in the market, severely limiting the liquidity of the financial institutions. As a result, Islamic banks have limited themselves to a small set of asset classes, which constrain their opportunities for portfolio diversification

and its benefits. Although this practice is conservative in its nature as assets are collateralized, it has associated costs from the additional exposure to credit and operational risk. This limited set of asset choices is a major impediment to the further growth of the Islamic financial services industry.

As mentioned earlier, Islamic financial institutions operate on a limited set of short-term traditional instruments and there is a shortage of products for medium- to long-term maturities. One reason for these shortcomings is the lack of markets in which banks can sell, trade, and negotiate their financial assets. There are no avenues for securitizing dormant assets and taking them off the balance sheet. In other words, the secondary markets lack depth and breadth. An effective portfolio-management strategy cannot be implemented in the absence of liquid markets, as opportunities for diversification become limited. Since the needs of the market for liquidity and risk and portfolio management are not being met, a serious effect of this underdevelopment is that the system is not functioning at its full potential. There is a growing realization that sustainable long-term growth largely depends on having well-functioning secondary markets and on the introduction of liquidity-enhancing and risk-sharing products.

### **Limited Scope**

In the absence of debt markets, the underdevelopment of equities markets and the lack of derivatives markets, the role of the financial intermediary providing Islamic financial services becomes critical. The financial intermediary not only becomes the main source of capital and risk mitigation, but is also expected to undertake other activities with a wider scope. The changing global financial landscape expects Islamic banks to go beyond their traditional core commercial banking role and develop other areas dealing with securities, risk management, and insurance businesses, which are currently either lacking or are on a limited scale.

The distinction between traditional commercial banking and investment banking is becoming blurred and there is a global trend of mixing financial services with non-banking services in an efficient fashion. Although this trend is prevalent in major industrial economies, it has not been embraced by many of emerging markets where Islamic finance is practiced. For example, a recent study, which ranked several countries in the Middle East region (where Islamic finance is dominant) according to their level of financial development, finds that throughout the region countries fared poorly on indicators for a strong institutional environment and for the development of the non-bank financial sector.<sup>3</sup>

### **Limited Maturity Structure**

The over-dependence of Islamic banks on trade and commodity financing instruments has limited their choice of maturity structure, since a major portion of such financing is of short-term maturity. Whereas the theoretical

models expect the financial intermediaries to participate in the full range of maturity structures to get the benefits of portfolio diversification, in reality, Islamic banks shy away from instruments requiring a medium- and long-term commitment. A cursory look at the data on the asset maturities collected from six Islamic banks in 2003 makes it clear that 54 percent of their assets had a maturity of less than one year and 39 percent, of less than six months. IFIs tend not to invest in longer maturities given the lack of liquidity of the medium- to long-term assets. With this reliance on short-term maturity, Islamic banks are unable to offer investment opportunities to investors who are interested in long-term investments.

### **Small Size and Fragmentation**

Although the number of Islamic financial institutions (IFIs) has grown, the average size of their assets is still small by comparison with their counterparts in the conventional system. As of 2010, the assets of the world's top Islamic bank equated to just 2 percent of those of the top conventional bank. Indeed, these assets amounted to only 35 percent of the conventional bank ranked at 120th. The top conventional bank of any Muslim country (Turkey) is ranked at 103 in the world (*The Banker* 2010a and 2010b).

Given their small size, Islamic banks are unable to reap the benefits of the economies of scale and scope and attendant efficiency gains.

### **Concentrated Banking**

Islamic banks tend to be concentrated in their deposit base or asset base, often concentrating on a few select sectors and avoiding direct competition. For example, one IFI may specialize in financing for the agriculture sector, whereas another might do the same in the construction sector without attempting to diversify into other sectors. This practice makes IFIs vulnerable to cyclical shocks in a particular sector. Dependence on a few select sectors, or a lack of diversification, increases an IFI's exposure to new entrants in the same sector, especially to foreign conventional banks that are better equipped to meet these challenges.

This concentration of the deposit or asset base can also be viewed as a lack of diversification, which increases their exposure to risk. Kahf (1999) showed that the average financing activities of IFIs have been primarily trade oriented (32 percent) followed by sectors such as industry (17 percent), real estate (16 percent), services (12 percent), agriculture (6 percent) and others (17 percent). Islamic banks are not fully exploiting the benefits of diversification, which come from both geographical and product diversification. At present, they rely heavily on maintaining good relationships with the depositors to earn the depositors' loyalty. However, this relationship can be tested during distress or changing market conditions, when the depositors tend to change loyalties and shift to large financial institutions that are perceived to be safer.

This risk of losing depositors raises a more serious exposure, termed “displacement risk.” Displacement risk refers to a situation where, in order to remain competitive, an IFI pays its investment depositors a rate of return higher than what should be payable under the “actual” terms of the investment contract, by forgoing part or all of its equity-holders’ profits, which may adversely affect its own capital. This is done to encourage its investment account holders not to withdraw their funds. Through a geographical diversification of the deposit base, an IFI can reduce its exposure to displacement or withdrawal risks. With the changing face of the banking business and the introduction of Internet-based banking, achieving a high degree of geographical diversity on the liabilities side is conceivable and should be encouraged.

## ENDNOTES

1. Chapra and Khan (2001).
2. The failure of Savings and Loans companies in the United States during the 1980s is a classic example of bank failures arising from assets-liabilities mismatch.
3. See Creane *et al.* (2003).

## CHAPTER 9

# Capital Markets

**T**he role of capital markets in promoting an efficient financial system cannot be overemphasized. Given that a developed financial system can make positive contributions to economic development, the existence of vibrant capital markets becomes a necessity for any economy. Capital markets facilitate long-term financing for businesses and entrepreneurs by attracting savings from a large pool of investors. These markets provide long-term capital to entrepreneurs through a series of short-term contracts (securities) with investors who may enter and exit the market at will. An efficient capital market is expected to perform the following functions:

- To provide a mobilization mechanism leading to an efficient allocation of financial resources in the economy.
- To provide liquidity in the market at the cheapest price; that is, the lowest transaction cost or low bid-ask spread on the securities being traded in the market.
- To ensure transparency in the pricing of securities by determining the price of the risk premia to reflect the riskiness of the security.
- To provide opportunities for constructing well-diversified portfolios and to reduce the level of risk through diversification across geographic regions and across time.

Capital markets consist of primary and secondary markets. Whereas primary markets are important to raise new capital and depend on the supply of funds, secondary markets make a significant contribution by facilitating the trading of existing securities. In some ways, secondary markets play an equally critical role by ensuring liquidity and fair pricing in the market and by giving valuable signals about the security. In other words, secondary markets not only provide liquidity and low transaction costs, they also determine the prices of the securities and their associated risk on a continuous basis, incorporating relevant new information as it arrives.

Just as capital markets play a critical role in the conventional financial system, their role in the Islamic financial system is equally important. Whereas conventional capital markets have an established track record, Islamic capital

markets are at a comparatively early stage of development. Conventional capital markets have two main streams: the securities markets for debt trading and the stock markets for equity trading. As we have seen, Muslims cannot participate in debt markets of any kind. The concept of stock markets is in consonance with the *Shari'ah*'s principles of profit/loss sharing, but not every business listed on the stock market is fully compatible with the *Shari'ah*. These issues present challenges for the development of Islamic capital markets.

The need for capital markets was realized at the early stages of development of the Islamic financial industry, but not much progress was made. During the 1980s and 1990s, Islamic financial institutions (IFIs) mobilized funds successfully through growing deposits, which were invested in a few financial instruments, mostly dominated by commodities or trade financing. However, limited investment opportunities, a lack of liquid assets and other constraints meant that the IFIs' asset composition remained fairly static and heavily focused on short-term instruments. With continuing demand for *Shari'ah*-compliant financing, there was a pressing need to develop capital markets to facilitate long-term financing for businesses and to create portfolio diversification opportunities for investors and financial intermediaries.

By the late 1990s, Islamic financial markets had realized that the development of capital markets was essential for their survival and growth. Meanwhile, the wave of deregulation and liberalization of capital markets in several countries led to close cooperation between IFIs and conventional financial institutions to find solutions for liquidity and portfolio management. Since then, several efforts have been made in this respect, particularly in the development of asset-backed securities and of Islamic funds comprising portfolios of securities such as, but not limited to, equity stocks or commodities. IFIs kept demanding a security that could behave like the conventional fixed-income debt security at a low level of risk but also complied with the *Shari'ah*. In addition, they wanted to extend the maturity structure of their assets to go beyond the typical short-term maturity given by trade-finance instruments. This led to experimentation with the *sukuk*, which has risk/return characteristics similar to a conventional debt security.

## **STOCK MARKETS AND ISLAMIC FUNDS**

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As discussed in Chapter 6, equities and stocks are the core capital markets in the Islamic financial system as they promote risk sharing and profit/loss sharing. With the exception of Malaysia, stock markets in Muslim countries are developing only gradually, forcing Islamic investors to invest in the stock markets of developed economies. However, there are certain rules which need to be followed in selecting stocks. Though there are growing numbers of Islamic funds becoming available that are *Shari'ah*-compliant, there is a need to develop stock markets in countries that are serious about developing Islamic finance. The concept of a market to trade equities is fully compatible with the *Shari'ah* but the operations and trading rules and practices should also be compliant.

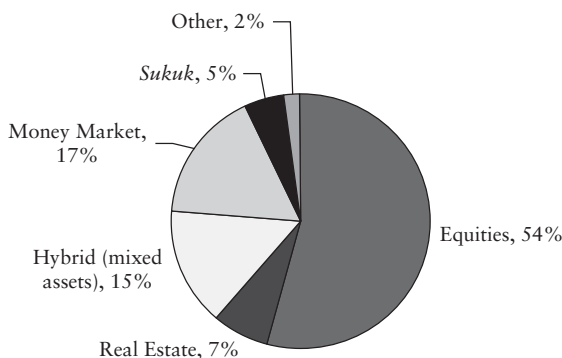


## Islamic Funds

Islamic investment funds emerged in the late 1980s, operating on the basis of a principal–agent model. Clients invest capital in the fund, which in turn channels capital only to select companies which satisfy *Shari'ah* requirements. Funds may be restricted to a specific asset class—such as real estate, leasing, commodities, or equities—or could be general purpose and diversified across asset classes, such as a hybrid of equities and commodities. As we have seen, Islamic investment funds operate on the basis of a variety of *Shari'ah*-compliant contracts, including *murabahah*, *musharakah*, *salam*, *istisna'*, and *ijarah*. The funds provide low-, medium-, and high-risk opportunities ranging from short-term (under one year) to long-term (over three years) maturity. Portfolios of *sukuk* are also available as investible funds. Figure 9.1 shows the breakdown of market share of different investment funds, illustrating that equity funds dominate the market.

Currently, there are about 750 Islamic funds, managing more than US\$50 billion-worth of assets. This is compared to more than 65,000 conventional funds, with more than US\$20 trillion in assets under management. It is worth noting that more than 50 percent of Islamic fund managers have less than US\$50 million under management. There is a growing trend of offering funds to institutional investors in addition to retail investors. For example, during the period 2005–10, 75 percent of funds introduced were targeted to institutional investors.

The principles underpinning activities of Islamic funds make for socially responsible investment and are therefore also attractive to non-Muslim investors interested in “ethical” finance. By performing the dual functions of risk intermediation and the effective allocation of excess liquidity, Islamic investment funds have earned a reputation as a fundamental pillar of the burgeoning Islamic financial industry.<sup>1</sup> They provide a wide array of portfolio-management options and mobilize long-term investments necessary for the expansion of capital markets.



**FIGURE 9.1** Distribution of types of Islamic funds, March 2011

Source: IFIS

With the growth of Islamic funds, a comprehensive array of indices which track the performance of *Shari'ah*-compliant equity portfolios are being offered by reputable sources such as Dow Jones. Empirical studies have concluded that *Shari'ah*-compliant funds have performed as well as—and, in some cases, better than—conventional funds, and there is no significant risk associated with investing in *Shari'ah*-compliant funds over conventional mutual funds. In fact, studies comparing the performance of Islamic and conventional funds before and during the global financial crisis of 2008 show that Islamic funds performed better on a risk-adjusted basis.<sup>2</sup>

### Equity Funds

Islamic equity funds are similar to the Socially Responsible Investment (SRI) funds of the conventional market. In constructing equity funds, the stocks of companies involved in businesses considered unlawful under the *Shari'ah* are screened out before a filtration process is applied by each fund manager regarding certain financial ratios such as the existence of debt or income from debt securities.

While the first part of this process is easy enough, the second part is not as straightforward because it relies on the judgment of individual fund managers, and different jurisdictions have different practices with regard to other filtering criteria. The following are the general guidelines used for screening and filtering the stock of a company before it is included in an equity fund.

- ***Shari'ah*-compatibility of business:** The main business of the company should be in conformity with the principles of the *Shari'ah*. This constraint eliminates all companies dealing with the financial services industry operating on interest, such as conventional banks and insurance companies; companies manufacturing, selling or offering liquor and pork products; and businesses involved in activities such as gambling, night clubs, casinos, pornography, and so on (see Table 9.1, for example).
- **Existence of debt:** Stocks of companies that depend heavily on debt financing, as determined by their debt ratio, are eliminated. Different funds set different levels of tolerance depending on how strictly they want to adhere to the *Shari'ah*. The typical level of tolerance is a maximum debt-to-equity ratio of 33 percent. This constraint is applied for ensuring that the company is capitalized in an acceptable manner and with the expectation that debt may be eliminated in the future. Some *Shari'ah* scholars, however, encourage shareholders to raise their voices against the use of debt financing altogether.
- **Interest income:** Fund managers also try to avoid those stocks where companies have substantial amounts of income derived from interest on securities. This could be the case of companies that invest excess liquidity in debt securities and therefore earn interest income that becomes part of the company's profits. However, if only a negligible portion of income is driven through interest, *Shari'ah* scholars have given permission to

**TABLE 9.1** Business activities excluded by the Dow Jones *Shari'ah* Board

Distillers and vintners	Restaurants and bars
Food products and tobacco	Conventional banks and financial institutions
Recreational products/services	Full-line insurance and insurance brokers
Harmful environmental records/ bad employee records	Conventional financial services
Food retailers and wholesalers	Property and casualty insurance
Broadcasting and entertainment / media agencies	Reinsurance and life insurance
Gambling / hotels / cinemas / pornography	Consumer finance
Alcohol and pork-related products	Human cloning and aborted human fetuses

Source: Dow Jones Islamic Market Index

acquire the stock on two conditions. First, the shareholder must express his disapproval against such dealings, preferably by raising his voice against such activities at the company's annual general meeting. Second, a cleansing of interest income should be done through a contribution to charity. It is suggested that the proportion of interest income in the dividend paid to the shareholder must be given in charity, and must not be retained by the shareholder. For example, if five percent of the company's income is derived from interest-bearing deposits, an equal percentage of the dividend must be given to charity to purify the income derived.

- **Negotiability of shares (liquidity test):** According to *Shari'ah* scholars, the shares of a company are negotiable only if the company owns some illiquid assets. Although there is no fixed tolerance level for illiquid assets, a ratio of 33 percent is typically used. The reasoning behind this constraint is that if all the assets of a company are in liquid form (that is, money), they cannot be purchased or sold except at par value, because money cannot be traded except at par.
- **Ordinary vs. preferred stock:** Although there is general consensus among *Shari'ah* scholars on the permissibility of ordinary shares, since they represent undivided ownership in the business of the company by the shareholders, other forms of shares such as preferred stock and warrants do not have the same permissibility. This is because, unlike ordinary shares, preferred stock and warrants promise a definite return to their holders.
- The demand for Islamic equity funds and the successful application of the screening process have been supported by the introduction of several equity indices. The Dow Jones Islamic Market Index (DJIMI), for example, was launched in February 1999, and was followed later that year by the Kuala Lumpur *Shari'ah* Index (KLSI) and the FTSE Global

Islamic Index Series (FTSE-GII). The market capitalization of the Global DJIMI as of February 28, 2011 was estimated to be US\$21.92 trillion, and the universe of *Shari'ah*-compliant stocks included 2,468 stocks (see <http://www.djindexes.com/islamicmarket/>). The number of the stocks included is relatively low because the DJIMI includes only those stocks that are open to an international investor who can repatriate the proceeds. As a result, several of the qualified local stocks are excluded. The screening process may also differ from index to index. For example, whereas the DJIMI applies ratios derived from both the income statements and the balance sheet, Malaysian indices use only income-statement ratios to determine debt or liquidity levels.

Table 9.2 shows the screening process used to construct the Dow Jones Islamic Index.

Figure 9.2 shows the trend of Islamic indices in different markets since 2004.

**TABLE 9.2** Dow Jones Islamic Index screening

**1. Screens for *Shari'ah*-compatible businesses:**

Based on revenue allocation, if any company has business activities in the *Shari'ah*-inconsistent group or sub-group of industries, it is excluded from the Islamic Index universe. The DJIMI *Shari'ah* Supervisory Board established that the following broad categories of industries are inconsistent with the precepts of the *Shari'ah*: alcohol, pork-related products, conventional financial services (banking, insurance, etc.), entertainment (hotels, casinos/gambling, cinema, pornography, music, etc.), tobacco, and weapons and defense industries.

**2. Financial ratios filter:**

Stocks of companies passing the following filter for financial ratios are included as components of the Dow Jones Islamic Market Index.

**2.1. Debt to Assets:**

Exclude companies if Total Debt divided by Trailing 12-Month Average Market Capitalization is greater than or equal to 33 percent. (Note: Total Debt = Short-Term Debt + Current Portion of Long-Term Debt + Long-Term Debt)

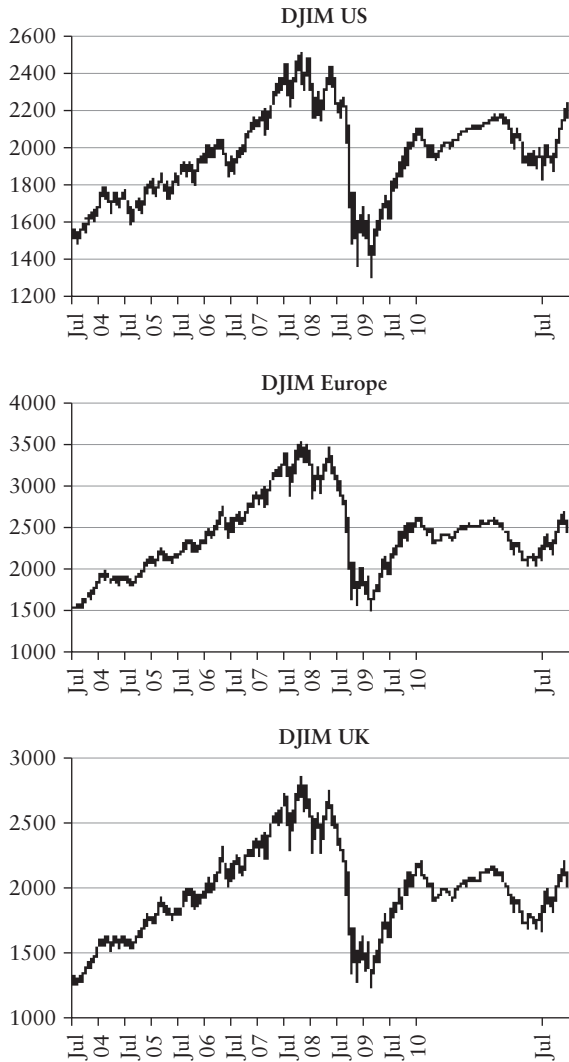
**2.2. Liquid Assets to Total Assets:**

Exclude companies if the sum of Cash and Interest Bearing Securities divided by Trailing 12-Month Average Market Capitalization is greater than or equal to 33 percent.

**2.3. Receivables to Assets:**

Exclude companies if Accounts Receivables divided by trailing 24-month average market capitalization is 33 percent or more.

Source: Syed (2005) and [www.djindices.com/islamicmarkets](http://www.djindices.com/islamicmarkets)



**FIGURE 9.2** Dow Jones Islamic Index trends in Global (DJIM), US and European markets

Source: IFIS

### Challenges for Equity Funds

The following issues and challenges need to be addressed for the further growth and development of Islamic equity funds:

- The compliance status of companies changes over time because of mergers and acquisitions, changes in the composition of business activities,

the availability of new financial information, changes in capital structure, and the daily change in market capitalization—the major decision-maker for *Shari'ah* financial ratios. This means that the compliance status needs to be monitored on a frequent basis so that:

- i) fund managers respond quickly to compliance changes
  - ii) *Shari'ah* boards are notified and consulted regarding status changes
  - iii) the necessary purification exercise is carried out with respect to status changes.<sup>3</sup>
- This means that Islamic funds require a higher degree of compliance and monitoring and support from good information and technology systems to ensure compliance.
  - The shallow stock markets in many OIC countries do not offer opportunities for meaningful portfolio construction after applying the screening criteria. Several of the listed stocks have weak financials and do not have depth in the market. In market capitalization terms, Malaysia has the largest segment of *Shari'ah*-compliant stocks, followed by the Karachi Stock Exchange (KSE), Turkey and Bahrain. The low proportion of *Shari'ah*-compatible markets is due to the high debt-to-equity ratio of a majority of the listed companies, which disqualifies them for inclusion in the equity funds.
  - The screening criteria are not very stable, as changing market conditions can change a company's financial ratios in such a way that it may or may not pass the filter set by the fund manager from one period to another. For example, depending upon the market price, a stock can be in and out of the fund during a relatively short period of time as a result of fluctuating debt-to-equity ratios. This can have an adverse effect on the diversification of the portfolio and may lead to additional transaction costs each time a portfolio is re-balanced.
  - As a result of the screening and filtering process, the resultant universe of stock may not be large enough to offer good opportunities for portfolio diversification. Efforts should be made to expand the universe of *Shari'ah*-compliant stocks.
  - On a more serious note, the main emphasis of fund managers has been on the screening mechanism, but little attention has been paid to certain market practices such as short-selling and margin account maintenance, which are not compatible with the *Shari'ah*. Practices followed by each fund manager should be clearly spelled out and should be cleared by *Shari'ah* scholars.

## Commodity Funds

Commodity funds are also popular among Islamic investors, whose contributions are used in purchasing commodities for resale. The profits generated by the sales represent the fund's income of the fund, which is distributed pro rata among the subscribers. Commodity funds are subject to certain conditions such as (i) short sales are not allowed; (ii) forward sales are allowed only in the case of *salam* and *istisna'*; and (iii) dealing in certain

commodities, such as pork or alcohol, is prohibited. Many of the commodity funds are developed by financial intermediaries or by conventional Western banks to cater to high-net-worth individuals.

## **DEVELOPMENT OF EQUITY MARKETS**

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The Islamic economic system relies upon vibrant markets for equity-based securities. A formal model for a stock market organized in strict accordance with Islamic principles has yet to be formulated, but there have been a few attempts to identify the issues that distinguish an Islamic stock market from its conventional counterpart. There are at least three major structural issues that need to be resolved, however, as set out below.

### **Limited Liability**

First and the foremost is the question of what is the best contractual agreement representing a share in a joint stock company with limited liability. Limited liability raises the issue of how to deal with a legal entity such as a corporation, which has a legal “personality” and needs to be treated as a “juridical person.” Some argue that limited liability conflicts with the basic Islamic moral and legal principle that obligations are, as it were, indestructible without agreed release of forgiveness from the creditor.<sup>4</sup> In this respect, *fiqh* scholars need to address several critical issues such as the acceptance of a corporation as a partnership (on a *musharakah* basis) or some other similar contract. In addition, what happens to the liability in case of the insolvency of the juridical person (that is, the company)? Some *Shari’ah* scholars are of the view that there are certain precedents wherefrom the basic concept of a juridical person may be derived by inference.<sup>5</sup>

### **Contractual Structure of an Equity Stock**

The second issue is related to the type of contract most appropriate to represent a common share as a partnership in a joint stock company. The *Shari’ah* identifies two broad categories of *musharakah* contracts: *musharakah mulk* which gives the partner ownership rights to a specific real asset; and *musharakah aqad*, which grants the partner ownership rights to the value of assets without any specific linkage to any real asset. It is important to understand this distinction. For example, if a stock is represented as *musharakah mulk*, then buying and selling of the stock will be equivalent to buying and selling an identifiable real asset and hence becomes subject to the rules applicable for *bay’* (trade/sale). On the other hand, if a stock is treated as *musharakah ‘aqd*, it is not subject to *bay’* rules but this raises other issues such as trading, valuation, and possession. A review of current rulings indicates that the joint stock company has been treated as a new form of *musharakah* which is neither of the above but a combination of the two, in that the rulings

regarding buying and selling stocks are largely treated under the former, while shareholder rights and basic investment operations are treated under the latter. This adds to the confusion surrounding the issue. Shabsigh (2002) argues that classifying the joint stock company as *musharakah mulk* renders most transactions in a stock market illegal from the *Shari'ah*'s point of view.

### **Negotiability and Tradability**

The third, and most critical, structural issue to be resolved is related to the negotiability, transferability and tradability of stocks in primary and secondary markets. While Islamic law encourages trading and markets in all tangible goods and properties, it restrains, if not prohibits, the trading of financial interests under the suspicion of trading leading, through a back door, to the prohibited element of *riba*. The law blocks trading in monetary obligations (such as *dayn* (debt), currency, or equivalents of currency), obligations demarcated in generic goods (for example, so many bushels of a particular grade of wheat), and even contingent or future rights generally. For example, the *Shari'ah* ruling being followed at present is that the stocks of a company are negotiable only if the company owns some non-liquid assets. If all the assets of a company are in liquid form (that is, money), the stock cannot be purchased or sold other than at par value. With the changing economic structure where there is a large number of economic entities engaging in providing services and holding illiquid assets, this poses serious problems. Consequently, a financial intermediary cannot exist in the form of a public company.

In addition to these structural issues, there are several operational aspects of conventional stock markets which are in direct conflict with the principles of Islamic markets. The following three operational differences are noteworthy.

### **Margin Accounts**

First, the widely accepted practice of maintaining a margin account to purchase stocks can be questioned. Since margin accounts allow a buyer to purchase stocks using leverage and borrowed funds at the prevailing interest rate, this arrangement cannot exist in the Islamic economy. The usage of leverage in stock trading will eliminate a large number of buyers from the market, which in turn will directly hamper the liquidity in the market and result in a higher transaction cost and operational inefficiency.

### **Speculative Trading**

Second, it is argued that trading in the stock markets opens the door to speculation and leads to practices amounting to gambling—another element strictly prohibited in Islam. The practice of day trading, which is popular in the conventional markets, raises the question of speculation. Earlier researchers in Islamic economics raised the concern that trading in stock markets is speculative and may contain the element of gambling, and



therefore measures need to be taken to eliminate or discourage speculative behavior. Recent scholars have distinguished between speculation and calculated risk taking based on information available in the market. Several measures have been suggested to reduce unwanted speculation and to eliminate the element of gambling. These measures include designing a tax structure that is linked to the holding period of investment, introducing greater transparency, regulating institutional investors who influence the market, and imposing restrictions on price changes so that no dealer is allowed to push prices upwards or downwards rapidly.

In the Islamic framework, although speculation is not unlawful per se, professional speculators cannot exist, because most speculation is made possible only with funds borrowed on the prohibited basis of interest. However, this counter-argument does not address the contribution of speculators to price discovery, liquidity and the efficiency of the markets.

On a related matter, it has been argued that the presence of *ghabun*, the difference between the price at which a transaction is executed and the fair price (as per the opinion of valuation experts), makes a transaction unethical. The consensus view seems to be that marginal over-pricing is permissible, but gross over-pricing should be curbed. The issue of fair prices is also a tricky one, as pricing is a function of the information available in the market and the expectations of investors about the market and the security. Any measure, other than the forces of demand and supply, introduced to enforce prices, will introduce unwanted distortions and inefficiencies.

### Short Selling

Third, the practice of short selling a stock is not compatible with the principles of Islam. According to Islam, an exchange contract is void unless the intention of the buyer is to buy and of the seller to sell, and that no-one sells what he does not have. This raises the question of trading a borrowed financial claim which does not appear to be compatible with *Shari'ah*. By eliminating the short-selling facility, markets will discourage speculative behavior but will also eliminate arbitrage opportunities, which may hamper price discovery.

Equity contracts and markets for equity-based capital are so vital in the Islamic financial system that the absence of such markets will hinder achievement of the full potential of the system. The structural and operational issues identified above are difficult but not insurmountable. Financial intermediaries cannot operate optimally without supporting markets and institutions in the financial system. Serious efforts should be made to encourage equity financing.

### SECURITIZED MARKET: *SUKUK*

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Efforts to develop and launch a *Shari'ah*-compatible bond-like security were made in Jordan as early as 1978, when the government allowed the Jordan Islamic Bank to issue Islamic bonds known as *muqaradah* bonds. This was

followed by the introduction of the *Muqaradah Bond Act* of 1981. Similar efforts were made in Pakistan, where a special law called the *Mudarabah Companies and Mudarabah Flotation and Control Ordinance* of 1980 was introduced. However, neither of these efforts resulted in any noteworthy activity, because of the lack of proper infrastructure and transparency in the market. The first successful introduction of Islamic bonds was by the Malaysian Government in 1983 with the issuance of the Government Investment Issues (GII)—formerly known as “Government Investment Certificates (GIC).” The pace of innovation was very slow and IFIs were unable to develop an active market for such securities. Meanwhile, the success of securitization of assets in the conventional markets provided a framework which could work for Islamic assets as well. It was not till the late 1990s that a well-recognized structure of an asset-backed security in the form of *sukuk* was developed in Bahrain and Malaysia. This structure is attracting the attention of borrowers and investors and is considered a potential vehicle to develop Islamic capital markets.

There are several advantages offered by a market for Islamic bonds or *sukuk* to meet the demands of the users of funds and a whole range of investors. The former gain direct access to the funds through the *sukuk* market and, at the same time, bypass intermediaries. They expect that an efficient *sukuk* market will ultimately lower their cost of funding. For investors, *sukuk* present them with greater choices on maturity and portfolio selection. A well-functioning primary and secondary *sukuk* market can provide much-needed liquidity to institutional investors and financial intermediaries, who become better equipped with portfolio and risk management. Finally, in many cases, the payoffs of *sukuk* resemble a conventional fixed-income debt security, which is popular among conventional investors. In this respect, *sukuk* can also serve as an integrating tool between Islamic and conventional markets.

### **What are *Sukuk*?**

The word *sukuk* (plural of the Arabic word *sakk*, meaning “certificate”) reflects participation rights in the underlying assets. The term is not new and is recognized in traditional Islamic jurisprudence. The idea behind *sukuk* is simple. The prohibition of interest virtually closes the door for a pure debt security, but an obligation that is linked to the performance of a real asset is acceptable. In other words, the *Shari’ah* accepts the validity of a financial asset that derives its return from the performance of an underlying real asset. The design of *sukuk* is very similar to the process of securitization in conventional markets where a wide range of asset types are securitized. These asset types include mortgages, auto loans, accounts receivables, credit card payoffs, and home equity loans. Just as in conventional securitization, a pool of assets is built and securities are issued against this pool. *Sukuk* are participation certificates against a single asset or a pool of assets.

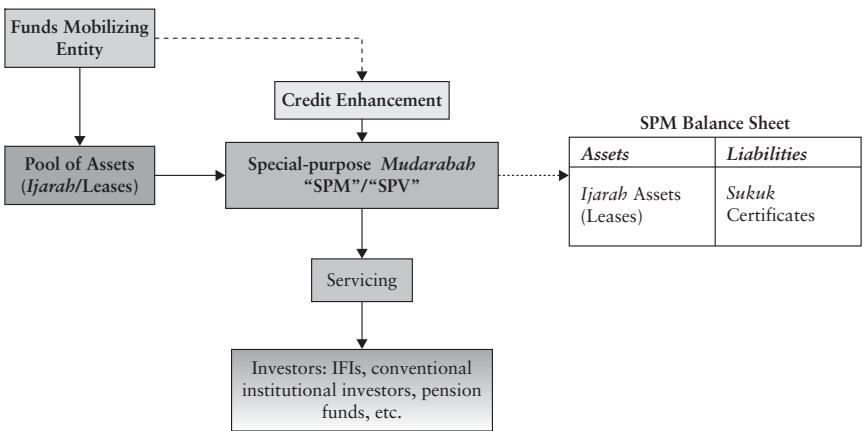
Formally, *sukuk* represent proportionate beneficial ownership of an asset for a defined period when the risk and the return associated with cash

flows generated by underlying assets in a pool are passed to the *sukuk* holders (investors). It is similar to a conventional bond as it is also a security instrument that provides a predictable level of return. However, a fundamental difference between the two is that a bond represents pure debt of the issuer but *sukuk* represent, in addition to the risk on the creditworthiness of the issuer, an ownership stake in an existing or well-defined asset or project. Also, while a bond creates a lender/borrower relationship, the relationship in *sukuk* depends on the nature of the underlying contract. For example, if the underlying contract is a lease (*ijarah*), this creates a lessee/lessor relationship, which is different from the typical lender/borrower relationship.

The core contract utilized in the process of securitization to create *sukuk* is the *mudarabah*, which allows one party to act as an agent (manager) on behalf of a principal (capital owner) on the basis of a pre-agreed profit-sharing arrangement. The *mudarabah* contract is used to create a special-purpose *mudarabah* (SPM) entity similar to the conventional special-purpose vehicle (SPV) to play a well-defined role in acquiring certain assets and issuing certificates against the assets. The underlying assets acquired by the SPM need to be *Shari'ah*-compliant and can vary in nature. The tradability and negotiability of issued certificates is determined on the basis of the nature of the underlying assets.

Figure 9.3 shows the process and linkage among the different players involved in structuring *sukuk*. This is a generic process and there will be differences depending on the type of underlying instrument used to acquire the assets. The structuring process involves the following steps:

**Step I:** An asset is identified, which is currently held by the entity wishing to mobilize resources and raise funds. In simple cases, this asset needs to be a tangible asset such as an office building, land, a highway, or an



**FIGURE 9.3** Anatomy of *sukuk*  
Source: Iqbal (1999)

airport. But in other cases, a pool could be made from a set of heterogeneous assets combining tangible and non-tangible assets; that is, financial assets. Once the assets to be securitized are identified, they are transferred to an SPM for a predetermined purchase price. The SPM is established solely for this particular purpose and is a separate legal entity that may or may not be affiliated to the issuer. By establishing an independent SPM, the certificates carry their own credit ratings, rather than those of its original owner. Also, by transferring the asset to this special entity, the asset is taken off the issuer's balance sheet and is therefore immune to any financial distress the issuer may face in the future. Thus, the existence of an SPM provides confidence to the investors (*sukuk* holders) about the certainty of cash flows on the certificates and therefore enhances the credit quality of the certificates. An SPM also enjoys special tax status and benefits, and is considered a bankruptcy-remote entity.

**Step II:** The underlying asset is brought onto the asset side of the SPM by issuing participation certificates (*sukuk*) on its liability side to investors in an amount equal to the purchase price. These certificates are of equal value, representing undivided shares in the ownership of the asset. The proceeds from the sale of certificates are used to purchase the assets. The holders of the *sukuk* participate in the equity interest of the SPM's assets, which are jointly owned.

**Step III:** The SPM either sells the asset or leases it back to a lessee—an affiliate of the seller or the seller itself—in exchange for a future payment or periodic lease payments. For example, in the case of a lease, the asset will be leased to a lessee or to the issuer who will be responsible for making future rental payment on the lease. These future cash flows in the form of rental income are passed through to the holders of the *sukuk*. The cash flows are subject to a deduction of minor administrative, insurance, and debt servicing fees.

**Step IV:** In order to make the certificates of investment quality and to enhance their marketability, an investment bank may also provide a guarantee, which may be in the form of a guarantee of performance regarding the future payments or a guarantee to buy or replace the asset in the event of default. The investment bank or guarantor charges a few basis points as premium for the guarantee. This credit enhancement makes the certificates investment-grade securities and therefore makes them attractive to institutional investors.

**Step V:** During the course of the life of the *sukuk*, periodic payments are made by the benefactor of the asset (the lessee), which are transferred to the investors. These periodic payments are similar to coupon payments on a conventional bond. Unlike payments on a conventional bond coupon, which accrues irrespective of the outcome of the project for which the bond was issued, *sukuk* payments accrue only if there is any income from the securitized asset. However, the interesting point is that in the case of a lease-based *sukuk*, since the coupon payments are based on rental income and there is a low probability of default on rental income, investors consider these coupons

to have high expectations and low risk. Anyone who purchases *sukuk* in the secondary market replaces the seller in the pro rata ownership of the relevant assets and all the rights and obligations of the original subscriber are passed on to him/her. The price is subject to the market forces and depends on the expected profitability. However, there are certain limitations to the sale of *sukuk* in the secondary market, which are discussed later in this chapter.

**Step VI:** At maturity, or on a dissolution event, the SPM starts winding up by selling the assets back to the original seller/owner at a predetermined price and then paying back to the certificate holders or investors. The price is predetermined to protect against capital loss to investors. It is a common practice that the *sukuk* contract embeds a put option for the holders by which the issuer agrees to buy the asset back at a predetermined price, so that at maturity the investors can sell the *sukuk* back to the issuer at the face value. At the completion of the *sukuk*, the SPM is dissolved and it ceases to exist since the purpose for which it was created has been achieved.

The above-mentioned process is a general process to issue *sukuk*, but there are different variations depending on the type of contract used to create the underlying asset. Due to the diversity of contracts that are available, the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) recognizes the following different types of *sukuk*:

1. Certificates of ownership of leased assets (*ijarah sukuk*)
2. Certificates of ownership of right to use: (i) of existing assets, (ii) of described future assets, (iii) of services of specified party, and (iv) of described future services
3. *Salam* certificates
4. *Istisna'* certificates
5. *Murabahah* certificates
6. *Musharakah* certificates
7. *Mudarabah* certificates
8. *Muzaraah* (share-cropping) certificates
9. *Musaqah* (irrigation) certificates
10. *Mugharasa* (agricultural/seed planting) certificates

With the exception of *salam*, *istisna'*, and *murabahah* certificates (and some particular cases of *muzaraah* and *musaqah* certificates when the certificate holder does not own the land) these are all *Shari'ah*-compatible for trading in the secondary market. This restriction on tradability in the secondary market comes from a *Shari'ah* ruling by the Organization of Islamic Countries (OIC) *Fiqh* council which states that "a bond or note can be sold at a market price provided that the composition of the group of assets, represented by the bond, consists of a majority of physical assets and financial rights, as compared to a minority of cash and interpersonal debts."

In other words, *sukuk* issued against a pool consisting of cash or debt-like instruments cannot be traded in the secondary market. This restriction

is imposed to avoid dealing with *riba* while trading debt securities in the secondary markets. *Shari'ah* is of the view that since *salam* and *murabahah* contracts create debt as the result of *salam*- and *murabahah*-based sale, *sukuk* based on these contracts cannot be traded in the secondary market.

Following is a discussion on selected types of *sukuk*.

***Ijarah Sukuk*** For *ijarah sukuk* to qualify for securitization, the underlying leasing contract must first conform to *Shari'ah* principles. Secondly, the leased assets must have some beneficial usage for which the users are willing to pay a rent. Third, the leased assets must be of such a nature that their use is fully compliant with the *Shari'ah*. For example, the leasing of a casino building would not be acceptable. Finally, the maintenance expenditure related to the underlying asset is the responsibility of the owner—in this case, the holders of the *sukuk*.

The *ijarah* contract offers several advantages, which make it a natural candidate for securitization. These include:

**Flexibility:** The *ijarah* is one of the instruments that is most similar to the conventional lease contract and offers the flexibility of both fixed- and floating-rate payoffs. The cash flows of the lease, including rental payments and principal repayment, are passed through to the investors in the form of coupon and principal payments. This makes them attractive to conventional investors as well. There is flexibility in the timing of inflows and outflows since it is not necessary that the cash flows to the certificate holders should coincide with the timing of the rental payments. Another element of this flexibility is that the *Shari'ah* does not require that the underlying asset to be securitized in this way be in existence at the time of the contract.

**Extended maturity:** The *ijarah* contract can be of any length as long as the asset that is the subject of the contract remains in existence and the user can draw benefit from it. The possibility of an extended term means that the *sukuk* can be structured to provide an efficient mode of financing with a medium-to-long-term maturity.

**Transferability:** Since *Shari'ah* rules do not restrict the right of the lessor to sell the leased asset, persons who share the ownership of a leased asset through *sukuk* can dispose of their property by selling it to new owners, individually or collectively, as they may desire. This feature is critical in developing a secondary market for *ijarah*-based *sukuk*.

**Negotiability:** The *Shari'ah* requires that a bond or note such as *sukuk* can be sold at a market price provided that the majority of its underlying assets are physical assets. This makes *ijarah sukuk* completely negotiable and capable of being traded in the secondary markets. This feature makes them attractive to investors as it enhances their liquidity in the market.

The *ijarah sukuk* is also subject to risks other than the market risk. These are related to the ability and willingness of the lessee to pay the rental payments over the life of the *sukuk*. In addition, the return to investors is not always predetermined, as the lease is subject to maintenance and insurance costs. Therefore, the amount of rent given in the contractual relationship indicates a maximum possible return subject to a deduction for maintenance

and insurance expenditures. However, given that risk is protected through insurance and financial risk may be protected through guarantees, the return to the investors is fairly stable.

In the case where an asset that can be sold and leased back does not exist, another type of contract, *istisna'* can be utilized. An *istisna'* contract is suitable for situations where a new asset is created through construction or manufacturing activity to a specified description and at a predetermined price. For such cases, *darrat sukuk* have been suggested, which are *sukuk* against assets which do not exist at the time of securitization. A combination of *istisna'* and *ijarah* is used in the structure of the contract to first create the asset and then to rent it back to the originator. In addition to the originator of the asset, a new party becomes involved—the contractor, who is responsible for the construction of the asset before it can be handed over to the SPM for leasing.

Figure 9.4 shows how *sukuk* based on an *ijarah* contract are structured. A special purpose vehicle (SPV) is used to securitize the *ijarah*-based assets. At the inception of the *sukuk*, the asset owner (obligor) transfers the asset to the SPV (issuer) which, in turn, exchanges ownership rights with the *sukuk* proceeds from *sukuk* investors. Over the life of the *sukuk*, periodic lease rental payments are made to the SPV, which passes it on to the investors. At maturity, the principal amount is returned to the investors in exchange for the leased asset.

**Salam Sukuk** *Salam*-based *sukuk* have proved to be a useful investment vehicle for short-term maturity, since the underlying commodity financing tends to be for short-term tenor, ranging from three months to one year. They can be based on either spot sale (*salam*) and/or deferred-payment sale (*Bay' al-Muajjil*) or deferred-delivery sale (*Bay' al-Salam*) contracts, whereby the investor undertakes to supply specific goods or commodities, incorporating a mutually agreed contract for resale to the client and a mutually negotiated profit margin. The Bahrain Monetary Agency (BMA) was one of the innovators and originators of early *salam*-based *sukuk*.

According to the structure promoted by BMA, an SPM is set up, which buys a commodity such as crude oil or aluminum on a *salam* basis, whereby the purchase price is paid entirely up-front with the proceeds from the *sukuk* certificates. The delivery of the purchased commodity is set at a specified future date and, subsequent to the *salam* contract, there is a promise by the beneficiary of the commodity to buy the commodity from the SPM on the due delivery date. The return on *sukuk* is determined by the pre-agreed cost of financing the purchase.

In addition to being short term, the *salam sukuk* has another special characteristic. Because it results in a pure financial claim and is somewhat de-linked from the risk/return of the underlying asset, the *Shari'ah* treats it as a pure debt security, which cannot be traded in the secondary market. To do otherwise would introduce an element of *riba* into the transaction. This feature adversely affects the transferability and negotiability of these certificates in the secondary market. As a result, investors have no option but to hold *salam sukuk* up to the maturity of the certificates.

Structure	Asset Type	Description	Benefits	Considerations
<i>Ijarah</i>	<ul style="list-style-type: none"> <li>Existing tangible assets such as plant, machinery, buildings etc.</li> <li>Usufruct rights pertaining to tangible assets can be considered as well</li> </ul>	<ul style="list-style-type: none"> <li>Involves a sale and leaseback of tangible assets (or their usufruct rights)</li> </ul>	<ul style="list-style-type: none"> <li>Most commonly-applied and accepted <i>sukuk</i> structure</li> <li>Tradable on secondary market</li> <li>Wide <i>Shariah</i> acceptability (AAOIFI-compliant)</li> <li>Relatively easy documentation process</li> </ul>	<ul style="list-style-type: none"> <li>Identification of assets</li> <li>100% of assets have to be tangible</li> <li>Assets remain in the ownership of investors till maturity</li> <li>Assets should be unencumbered at time of sale</li> </ul>
Head-lease & Sub-lease	<ul style="list-style-type: none"> <li>Existing tangible assets</li> </ul>	<ul style="list-style-type: none"> <li>Involves long- and short-term leases of tangible assets</li> </ul>	<ul style="list-style-type: none"> <li>Tradable on secondary market</li> <li><i>Shariah</i> acceptability</li> <li>Template document available</li> <li>Avoid sale of assets which can be sensitive in certain jurisdictions</li> </ul>	<ul style="list-style-type: none"> <li>Tangible assets required; with possibility of using suitable operating rights as underlying assets (subject to <i>Shariah</i> approval)</li> <li>Long-term lease has to be for a period of more than 50 years (for <i>Shariah</i> structuring purposes)</li> </ul>
<i>Wakala</i>	<ul style="list-style-type: none"> <li><i>Ijara</i> assets</li> <li><i>Shariah</i>-compliant equity instruments</li> <li><i>Sukuk</i> certificates</li> </ul>	<ul style="list-style-type: none"> <li>Involves appointing the obligor as investment agent to manage the assets for a fee</li> </ul>	<ul style="list-style-type: none"> <li>Easily executable if <i>Shariah</i> compliant assets are available</li> <li>Used by surplus with <i>Shariah</i> compliant asset portfolios</li> </ul>	<ul style="list-style-type: none"> <li>Identification of assets and substitution</li> <li>Assets need to have value at or greater than amount raised</li> </ul>
<i>Istithmar</i>	<ul style="list-style-type: none"> <li>Revenue generating agreements</li> <li>Linked to business activity</li> </ul>	<ul style="list-style-type: none"> <li>Transfer of certain rights and obligations to issuer</li> <li>Income from agreements are used to service the periodic payments</li> </ul>	<ul style="list-style-type: none"> <li><i>Shariah</i> acceptability</li> <li>No tangible assets required</li> <li>Assets can be long-term agreements</li> <li>Template documents available</li> <li>Issuer does not give up operating control of the business</li> </ul>	<ul style="list-style-type: none"> <li>Identification of assets and suitability</li> <li>Size of <i>sukuk</i> limited to size of business and require significant due diligence on business</li> <li>Non-Middle Eastern investors may require more education on the structure</li> <li>Introduces 'business' risks (performance risk of company) which is not a typical credit risk</li> </ul>

**FIGURE 9.4** *Sukuk al-ijarah* structure  
Source: HSBC Amanah, Malaysia.



**Bai' Bithamin Ajil Sukuk** *Sukuk* based on *Bai' Bithamin Ajil* (BBA) is an innovation of the Malaysian market. The contract is based on a sale of an asset to investors, with a promise by the issuer to buy the asset back in the future at a predetermined price which also includes a margin of profit. Therefore, the issuer gets immediate cash against the promise to buy back at the purchase price plus a pre-agreed profit, which creates an obligation to be released over an agreed period. The issuer issues securities to the investors to reflect this financing arrangement. Investors expect to earn a return equal to the pre-agreed profit.

This structure is not very popular with Middle Eastern investors because of a debatable *Shari'ah* issue, which does not accept the tradability of debt. In addition, some BBA issuances in Malaysian markets are based on financial assets—which is also an objectionable practice in the eyes of *Shari'ah* scholars in the Middle East.

**Muqaradah Bonds** *Muqaradah* bonds are based on the *mudharabah* contract whereby the capital is provided by a pool of investors against certificates or bonds for a specific project undertaken by an entrepreneur (*mudharib*) with the agreement to share revenues. In this respect, they bear close resemblance to revenue-bond financing in the conventional system, where bonds are generally backed only by the revenue generated by the project funded by the bond issue. These bonds are suitable for undertaking development projects to build networks of roads or other infrastructure projects. Investors have the right to share in the revenues generated by the project. Investors are solely dependent on the revenues generated by the project and they have no recourse to the *mudharib*. On the expiry of the specified time period of the subscription, investors are given the right to transfer the ownership by sale or trade in the securities market at their discretion.

The concept of the *muqaradah* bond was for raising capital for public finance projects, but for several reasons, such as a lack of transparency in the public sector and a lack of liquidity, these bonds did not gain much popularity with investors.

**Musharakah Bonds** As their name implies, *musharakah* bonds are based on the partnership and profit/sharing contract and are similar to *muqaradah* bonds. The major difference is that the intermediary or the entrepreneur is a partner with the investors (the group of subscribers) as well as acting like an agent (*mudharib*). Several *musharakah*-based bonds have been issued by the Islamic Republics of Iran and Sudan. In the case of Iran, *musharakah* certificates were devised and approved by the Money and Credit Council to finance the Tehran Municipality. Sudan has made considerable progress in the development of *musharakah*-based certificates and, with the help of the IMF, designed *musharakah* bonds based on state ownership of key profitable and large public enterprises, which can be traded in the market. A similar arrangement was launched by the central bank for the purposes of Treasury intervention and open-market operations for managing monetary policy. Another example of a successful

launch of *musharakah* bonds was in Turkey in 1984 to finance the construction of a toll bridge in Istanbul.

Being based on profit/loss-sharing principles, both *muqaradah* and *musharakah* bonds are ideal for the promotion of Islamic finance. However, although the issuers of these bonds are public-sector institutions, the low transparency that prevails in the affairs of governments of several Muslim countries keeps investors away from this structure. With enhanced monitoring and transparency, and with a reduction of asymmetrical information, these bonds could make a greater contribution to the development of Islamic capital markets.

Table 9.3 summarizes comparative features of the four most prevalent *sukuk* structures. This demonstrates how different structures provide different risk/return profiles and can be customized to meet the needs of borrowers as well as of investors.

### The *Sukuk* Market

The market for the *sukuk* was originated by government entities and although the market is still dominated by the sovereign issues, corporate issues are gradually emerging. In terms of total amount outstanding, the current ratio between sovereign and corporate *sukuk* is 3.5:1. With a growing *sukuk* market, many conventional rating agencies, including Standard & Poor's (S&P) and Fitch, have started to rate select issues. For example, S&P has now designed a methodology to rate *ijarah*-based *sukuk*. In another positive development, Dow Jones has announced plans for a *Sukuk* Index to monitor the performance of this market. Another particularly encouraging sign in the *sukuk* market is that it is no longer the sole preserve of specialist Islamic issuers or investors. For example, 48 percent of a recent sovereign issue was subscribed for by conventional investors, comprising 24 percent by institutional investors, 11 percent by fund managers and 13 percent by central banks and government institutions.

Table 9.4 lists the top 10 investment banks (lead managers) that were active in underwriting *sukuk* issues during the period 2005–10. The majority of these are based in Malaysia, reflecting the major role played by that country in developing the *sukuk* market. Another notable performance is by the Hong Kong and Shanghai Banking Corporation's (HSBC) Islamic investment entity—*Amanah*—which has also played an important role in the development of this market.

The *sukuk* market has been used by both public (sovereign and quasi-sovereign) and corporate entities. Table 9.5 lists the number of *sukuk* issues by sector and Table 9.6 shows the size of these issues by issuer type. As compared to conventional finance, where government and sovereign sectors dominate, the *sukuk* market shows little activity by sovereigns and this serves to hinder the establishment of a benchmark which can be used to price private sector or corporate issuers. The *sukuk* market suffered during the 2008–09 financial crisis and economic slowdown but rebounded in 2010.

**TABLE 9.3** Comparison of four basic *sukuk* structures

Structure	Asset Type	Description	Benefits	Considerations
<i>Ijarah</i>	<ul style="list-style-type: none"> <li>Existing tangible assets such as plant, machinery, buildings, etc</li> <li>Usufruct rights pertaining to tangible assets can be considered as well</li> </ul>	<ul style="list-style-type: none"> <li>Involves a sale and leaseback of tangible assets (or their usufruct rights)</li> </ul>	<ul style="list-style-type: none"> <li>Most commonly applied and accepted structure</li> <li>Tradable on secondary market</li> <li>Wide <i>Shari'ah</i> acceptability (AAOIFI-compliant)</li> <li>Relatively easy documentation process</li> </ul>	<ul style="list-style-type: none"> <li>Identification of assets</li> <li>100% of assets have to be tangible</li> <li>Assets remain in the ownership of investors till maturity</li> <li>Assets should be unencumbered at time of sale</li> </ul>
Head-lease and sub-lease	<ul style="list-style-type: none"> <li>Existing tangible assets</li> </ul>	<ul style="list-style-type: none"> <li>Involves long- and short-term leases of tangible assets</li> </ul>	<ul style="list-style-type: none"> <li>Tradable on secondary market</li> <li><i>Shari'ah</i> acceptability</li> <li>Template document available</li> <li>Avoid sale of assets which can be sensitive in certain jurisdictions</li> </ul>	<ul style="list-style-type: none"> <li>Tangible assets required; with possibility of using suitable operating rights as underlying assets (subject to <i>Shari'ah</i> approval)</li> <li>Long-term lease has to be for a period of more than 50 years (for <i>Shari'ah</i> structuring purposes)</li> </ul>

(Continued)

TABLE 9.3 Continued

Structure	Asset Type	Description	Benefits
<i>Wakala</i>	<ul style="list-style-type: none"><li>• <i>Ijarah</i> assets</li><li>• <i>Shari'ah</i>-compliant equity instruments</li><li>• <i>Sukuk</i> certificates</li></ul>	<ul style="list-style-type: none"><li>• Involves appointing the obligor as investment agent to manage the assets for a fee</li></ul>	<ul style="list-style-type: none"><li>• Easily executable if <i>Shari'ah</i>-compliant assets are available</li><li>• Used by supranationals with <i>Shari'ah</i>-compliant asset portfolios</li><li>• Identification of assets and substitution</li><li>• Assets need to have value at or greater than amount raised</li></ul>
<i>Istisna'</i>	<ul style="list-style-type: none"><li>• Revenue-generating agreements</li><li>• Linked to business activity</li></ul>	<ul style="list-style-type: none"><li>• Transfer of certain rights and obligations to Issuer</li><li>• Income from agreements are used to service the periodic payments</li></ul>	<ul style="list-style-type: none"><li>• <i>Shari'ah</i> acceptability</li><li>• No tangible assets required</li><li>• Assets can be long-term agreements</li><li>• Template documents available</li><li>• Issuer does not give up operating control of the business</li><li>• Identification of assets and suitability</li><li>• Size of <i>sukuk</i> limited to size of business and require significant due diligence on business</li><li>• Non-Middle Eastern investors may require more education on the structure</li><li>• Introduces "business" risks (performance risk of company) which is not a typical credit risk</li></ul>

Source: HSBC Amanah, Malaysia.

**TABLE 9.4** League table for *sukuk* issuance

From 2005-01-01 to 2009-12-31			
Ranking	Bookrunner / Lead Manager	Amount (US\$m)	Issues
1	CIMB Islamic	12,179.19	94
2	HSBC Amanah	9,011.77	54
3	Citigroup	3,128.84	19
4	Barclays Capital	2,840.54	8
5	Deutsche Bank	2,588.53	8
6	Standard Chartered Bank	2,438.01	30
7	ABN-Amro Bank Bhd	2,392.20	4
8	Bank Negara Malaysia	2,388.45	2
9	Dubai Islamic Bank	2,344.54	14
10	JP Morgan	2,033.33	3

Source: IFIS

**TABLE 9.5** *Sukuk* issuance by issuer type

Issuance Type	2005	2006	2007	2008	2009	2010
Sovereign	3	32	42	38	66	128
Quasi Sovereign	3	12	21	27	90	39
Corporate	82	164	137	134	600	512
Total	88	208	200	199	756	679

**TABLE 9.6** Total *sukuk* issuance by issuer type (US\$ million)

Issuance Type	2005	2006	2007	2008	2009	2010
Sovereign	706	1,423	5,337	1,839	12,781	24,004
Quasi Sovereign	574	7,021	13,919	5,087	12,463	7,925
Corporate	9,942	17,693	25,671	9,758	6,646	9,634
Total	11,223	26,137	44,927	16,684	31,890	41,564

Table 9.7 provides a breakdown of the *sukuk* market by currency in each sector. Although *sukuk* have been issued in several currencies, two currencies—US dollars and Malaysian Ringgit (MYR)—dominate all the sectors. While the size of *sukuk* issuance is growing, it remains very small by comparison with global conventional securitized and debt markets.

**TABLE 9.7** *Sukuk* issuance by issuer

Sovereign							
Currency	2005	2006	2007	2008	2009	2010	Total
AED				200	680		880.49
BHD	107	318	569	351	712	564	2,619.32
BND		380	188	51	130	127	876.08
GMD				0			0.21
IDR				508	1,052	1,726	3,286.58
MYR		111	2,185	128	6,528	19,253	28,204.22
PKR		134	339	161	362	466	1,462.05
QAR						343	343.29
SDD						200	200.00
USD	600	480	2,023	350	3,045		6,498.36
Total	707	1,423	5,304	1,749	12,510	22,679	44,370.60
Quasi-Sovereign							
Currency	2005	2006	2007	2008	2009	2010	Total
USD	500	4,270	2,350	1,300	3,450	519	12,389.28
AED	–	–	–	1,852	–	–	1,852.19
MYR	45	2,729	10,125	1,873	6,799	4,348	25,918.14
SAR	–	–	1,333	–	1,867	1,900	5,099.66
SGD	–	–	–	–	162	1,094	1,255.83
Others	29	22	111	62	186	64	474.32
Total	574	7,021	13,919	5,087	12,463	7,925	46,989.42
Corporates							
Currency	2005	2006	2007	2008	2009	2010	Total
USD	1,660	6,273	8,425	490	500	2,155	19,503.31
AED	–	–	2,042	3,039	–	–	5,081.35
MYR	7,983	10,592	12,100	3,924	5,299	7,067	46,964.95
SAR	–	800	2,100	1,874	393	187	5,354.04
PKR	–	29	625	189	182	4	1,027.79
Others	299	–	379	242	273	221	1,413.78

Notes: AED (UAE Dirham), BND (Brunei Dollar), BHD (Bahrain Dinar), GMD (Gambian Dalasi), IDR (Indonesian Rupiah), MYR (Malaysian Ringgit), QAR (Qatari Rial), SDD (Sudanese Dinar), SAR (Saudi Riyal), PKR (Pakistan Rupee), SGD (Singapore Dollar), USD (US Dollar)

## CASE STUDY: ISLAMIC DEVELOPMENT BANK

On September 9, 2009, the Islamic Development Bank (IDB) launched the following five-year, US\$850 million *sukuk*. This was the third, and largest, public US dollar-denominated *sukuk* executed by IDB.

Issuer	IDB Trust Services Limited
Obligor	Islamic Development Bank (IDB)
Currency/Format	US\$/Fixed Rate Regulation S
Structure	<i>Sukuk</i> based on <i>wakalah</i> (agency) structure
Obligor/ <i>Sukuk</i> Ratings	Aaa/AAA/AAA
<i>Sukuk</i> Assets	Portfolio of assets owned by IDB comprising <i>ijarah</i> contracts, <i>Shari'ah</i> -compliant equity instruments and/or <i>sukuk</i> certificates
Amount	US\$850 million
Pricing/Settlement Date	9 September 2009/16 September 2009
Maturity Date	16 September 2014
Periodic Distributions	3.172% semi-annual
Price/Re-offer Spread	100.00/MS+40bps
Listing	London Stock Exchange
Governing Law	English Law
Joint Lead Manager and Joint Bookrunner	HSBC Amanah

### Transaction Highlights

- Book-building swiftly gained momentum with the announcement of the price guidance of MS+40–43 bps, resulting in the order book reaching US\$2 billion, at 2.4x oversubscribed with 90 accounts
- The strong bid enabled the transaction to price at the tight end of the price guidance, at a yield of 3.172 per cent
- Distribution was evenly spread geographically and by investor type, thereby achieving IDB's strategic objective of investor diversification into Europe and Asia. Approximately 65 per cent of the issue was placed outside of the Middle East and North Africa region. The issue saw strong distribution to central banks and reserve managers (21 per cent), with the balance taken up by banks (40 per cent), fund managers (34 per cent) and private banks (5 per cent)

### CASE STUDY: ISLAMIC DEVELOPMENT BANK (CONTINUED)

Breakdown by Geography



■ Middle East (35%)  
 ■ Asia (30%)  
 ■ Continental Europe (20%)  
 ■ United Kingdom (15%)

Breakdown by Type



■ Central Banks (21%)  
 ■ Banks & Treasury (40%)  
 ■ Private Banks (5%)  
 ■ Fund/Asset Managers (34%)

The offering marks a major step for IDB's future, diversifying its investor base into new accounts and establishing a strong benchmark for IDB's future issuances

Source: HSBC Amanah, Malaysia.

### Limitations of the *Sukuk* Market<sup>6</sup>

*Sukuk* issuance to date has been concentrated in Malaysia and the Middle East, particularly in Bahrain. Outside of those two markets, the *sukuk* occupies only a very small place in the capital markets landscape. We believe the principal limitations on the development of the *sukuk* market are as follows.

First, the *sukuk* market suffers from a lack of frequent sovereign issues. In particular, high-quality sovereign issues, which play an important role in the development of all capital markets and serve the critical purpose of building a benchmark yield curve for the market, are largely absent from this market.<sup>7</sup> Without a benchmark yield curve, it is difficult for other issuers and investors to access the market with confidence.

Second, many investors in this market tend to buy and hold *sukuk* investments until maturity, and, as a result, there is almost no secondary market in most *sukuk* issues. The prevalence of "buy and hold" investors in this market is largely a consequence of an acute lack of supply such that investors know that if they sell the *sukuk* it will be difficult to find another to replace it in their portfolio.

Third, and directly related to the point above, the lack of liquidity of most *sukuk* issues hampers the growth of the market. Investors that place a high value on liquidity may avoid *sukuk* entirely because of the absence



of a secondary market. The illiquidity also harms dedicated *sukuk* investors, because it leads to comparatively large bid-ask spreads and limits their investment strategies and opportunities for portfolio diversification.

The global financial crisis highlighted in stark terms the importance of liquidity. As a result, the lack of liquidity is increasingly detrimental to the market and directly impacts the assessment by both investors and regulators of the overall asset quality of *sukuk*.

Buying and holding and the corresponding lack of liquidity have serious implications for portfolio management. As a fixed-income security ages, it moves from one benchmark to another. For example, a five-year bond may be initially included in a one–five-year benchmark, but as it ages and the remaining maturity comes closer to three years, the bond may be dropped to a one–three-year benchmark. In the conventional markets, periodic “re-balancing” of portfolios to reflect the change in the remaining duration of outstanding holdings is relatively inexpensive to achieve, but in the case of *sukuk*, where the secondary market is very shallow, re-balancing could have a negative impact on portfolio performance in a material way.

Fourth, the complexity of *sukuk* structures is another impediment to the development of this market. *Shari’ah* compliance is often achieved through creating a complex set of cash flows, and the prospectus for even a relatively simple *sukuk* will generally include a cash flow diagram replete with multiple boxes and arrows. Essentially, this is a market where every product is a structured product, even ones that replicate in their credit risk plain vanilla, unsecured bonds.

The global financial crisis also drew attention to the dangers of highly complex structured products. Specifically, such products are difficult to value, as well as to unwind in the event of a default. Because of the similarity of *sukuk* to conventional asset securitization, many of the same banks and professional advisors who dominated the market in complex collateralized debt obligations (“CDOs”) and other complex products that suffered significant downgrades and defaults during the financial crisis are also leaders in the business of structuring *sukuk*. Although the *sukuk* market proved itself to be more resilient than many segments of the CDO market during the financial crisis, the complexity of their structures may continue to discourage participation from many investors and issuers who were burned by structured products.

The lack of uniform interpretations across jurisdictions further hinders the growth of the market. Structures that are deemed acceptable in one market may not be equally accepted in another jurisdiction. The most frequently cited example of this divergence in interpretation is the difference between structures that are considered tradable in Malaysia and those that can be traded in most Gulf countries. Such a lack of uniformity limits the depth of the market for any particular *sukuk* issue.

There are also concerns about the lack of legal certainty in the *sukuk* market. For example, the extent to which courts will consider *Shari’ah* compliance in evaluating the enforceability of an Islamic finance contract remains an open question in most jurisdictions. As a result, there is a risk

that a contractual obligation that would otherwise be found to be enforceable under the governing law of the contract may nonetheless be determined to be unenforceable due to some deficiency in its compliance with *Shari'ah* principles. This risk was highlighted by the 2009 English High Court judgment in *The Investment Dar Company KSCC v. Blom Developments Bank* case, in which the court found reasonable grounds for a claim by an Islamic finance house that its obligations under a contract governed by English law were unenforceable because the contract was not truly compliant with *Shari'ah* law.

There is also a lack of legal certainty with respect to the recourse to assets underlying many *sukuk* issues in the event of the insolvency of an obligor. While the existence of an underlying transaction involving real assets is an essential component of most *sukuk* structures, many issues are “asset-based,” as opposed to “asset-backed” or “asset-linked.” In an asset-based structure, there is rarely a security interest granted in, or recourse to, the assets involved in the transaction. This issue was highlighted in a *Shari'ah* ruling of AAOIFI which criticized existing structures on these grounds. In particular, *Shari'ah* experts have criticized the fact that many agreements underlying asset-based *sukuk* transactions stipulate that the underlying assets are to be bought back at par instead of at prevailing market value.

### Challenges for the *Sukuk* Market

The *sukuk* market is in its embryonic phase, but holds great potential for further growth of the Islamic financial industry. The following are some of the issues currently faced by this market:

- The *sukuk* issued so far (with the exception of those by the Islamic Development Bank) have been linked to a particular real asset, rather than to a pool of assets. This model can work for sovereign, supra-national or multilateral borrowers who have large-scale assets to securitize, but poses difficulty for institutions that want to raise capital on a smaller scale. In addition, *sukuk* issued against *salam* or *murabahah* contracts cannot be traded in the secondary markets. The majority of Islamic banks hold a large portion of assets that can be securitized, but so far no Islamic commercial bank has issued *sukuk*, mainly due to the lack of large-scale assets or the holding of short-term *salam* or *murabahah*-based assets. Islamic banks should make serious efforts to utilize the securitization process to take the assets off their balance sheets in order to enhance the liquidity of their existing portfolios. The challenge is to develop *sukuk* based on pools of heterogeneous assets with varying maturities and different credit qualities. The participation of Islamic banks will further develop the market.
- Issuers, investors and intermediaries need to nurture the market patiently. Islamic transactions often face a competitive disadvantage vis-à-vis conventional bond issues in cost-efficiency terms. Each new issue incurs

higher levels of legal and documentation expenses as well as distribution costs; and involves examining structural robustness in addition to evaluating the credit quality of the obligor. Standardization of contracts will reduce this problem.

- Floating-rate *sukuk* are often linked to a conventional interest rate benchmark such as the London Inter Bank Offer Rate (LIBOR). When it comes to pricing, *sukuk* compete directly with the conventional bonds in the level of relative spreads. From the conventional borrowers' point of view, there is no inherent cost advantage to be gained from tapping into *sukuk* markets, since the terms available are mostly derived from competitive pricing levels in the more liquid and cheaper conventional bond market. Borrowers, therefore, need to formulate a comprehensive, long-term and strategic view on how to reduce the overall funding cost by tapping into Islamic markets, rather than focusing on a single transaction.
- In principle, *sukuk*-based funding should be cheaper, since it is based on collateralized cash flows, but in reality this is not the case. It is expected that as the market matures and investors are more comfortable with the instrument, costs will decrease and the market will become more efficient.
- Due to the shortage of good quality bond issues in the *sukuk* market, subscribers, which include institutional investors, central banks, and private-sector Islamic banks, tend to hold the *sukuk* till maturity. As a result, the level of activity in the secondary market is low, which, in turn, reduces liquidity and also increases transaction costs by the way of high bid-ask spreads. This problem can be overcome by increasing the supply of *sukuk* and by developing a market for retail investors.
- There may be intermediation costs involved in issuing *sukuk* when more than one layer of investment banks is involved. Conventional banks often co-lead an issue with the Islamic banks and may be taking a larger share of fees. Also, a conventional investment bank may not be willing to invest time and effort to develop small-scale *sukuk* in the local market. This gap should be filled by a more active involvement of Islamic investment banks.
- It should also be noted that with *sukuk* the need for monitoring costs has not been eliminated entirely. In order to obtain a contract on favorable terms, borrowers may be tempted to exaggerate their competence, ability, or willingness to provide what the principal requires. In such cases, the principal, in order to protect its interests, often requires that borrowers provide evidence that they can indeed perform the task in the manner required. In order to protect themselves from adverse selection, principals (investors) may enter into contracts with entrepreneurs who have the necessary credentials, with the assurance that these agents are competent and trustworthy. Investment banks can play a critical role in reducing the potential for making a wrong choice by conducting due diligence and providing a transparent execution of the deal.

## CHALLENGES FOR DEVELOPING AN ISLAMIC CAPITAL MARKET

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Developing capital markets is not an overnight task. Today's conventional capital markets are the result of years of evolution, and this has enabled them to cope with the unprecedented pace of innovation that has been evident in the last couple of decades. Islamic capital markets can learn and benefit from the rich experience of the conventional markets to reduce their own development time.

Today's capital markets do not operate in isolation but, rather, are part of a complex system that comprises several different components: the state of the regulatory system, the quality of supporting institutions, the design of the incentive and corporate-governance systems, and market micro-structure and practices. In addition, other factors like the breadth of the market determined by the product range, the existence of reliable benchmarks for performance evaluation, the culture of market players and the degree of integration with external markets are also critical to the development of an efficient capital market.

The major challenges facing the development of Islamic capital markets are discussed below.

### Legislative and Regulatory Framework

The existence of a strong legislative and regulatory framework is essential for capital markets. Laws to protect the rights of investors and mechanisms to resolve disputes in an efficient manner help in establishing the confidence of the investors. This issue has become increasingly relevant given the greater competition to attract cross-border investors.

The majority of Muslim countries in which there is a demand for Islamic products lack a sound legal and regulatory system. In many cases, amendments are made to local laws and regulations on an ad-hoc basis to accommodate the needs of a transaction, but this style of operation is inefficient as well as frustrating for the players in the market. The framework should facilitate the smooth execution of transactions without creating any of the technical, legal or regulatory issues that recent *sukuk* issues have raised. For example, an *ijarah sukuk* transaction requires the owner of the operating assets to enter into a leasing transaction. While the owners are often governments or their related public-sector bodies, the relevant laws and regulations in the host country may not allow these public-sector bodies to pledge or lease assets needed to structure the transaction. This is a fundamental point: the host country's policy actions to promote such Islamic finance will be a key prerequisite for the market to develop further.

The following suggestions are made in this respect:

**Standardization of Legal Framework** One major reason for this inefficiency is that the majority of the markets in Islamic countries operate in a legal system subject to conventional civil and common law, which may not always be compatible with the *Shari'ah*. Different legal environments from country to country make the task of introducing new products very difficult and costly. Countries wishing to develop Islamic capital markets need to review the legal system as a whole and make serious efforts to ensure that the legal framework complies with the *Shari'ah*. Countries should make coordinated efforts to ensure that their legal systems are standardized and harmonized in order to remove any ambiguity regarding the status of Islamic capital market transactions undertaken in a particular jurisdiction.

**Dispute Resolution** In the countries in which Islamic capital markets are being developed alongside conventional markets, the existence of different legal systems for addressing issues with Islamic instruments is not an ideal situation. In order to minimize any confusion, amendments should be made to accommodate Islamic instruments within the framework of existing dispute-resolution procedures, rather than setting up a separate, dedicated system. The approach to dispute resolution should aim to avoid duplication of resources and maintain the confidence in Islamic products.

**Strengthening the Regulatory Framework** While rules exist in a number of markets, the enforcement of them is often weak. The regulatory authorities should play a more active role in the development of capital markets by strengthening the regulatory framework and by establishing the credibility of the regulatory institutions. In many Islamic countries, regulatory institutions either do not exist or are very weak. Having independent regulatory and supporting institutions will serve to further promote and strengthen Islamic capital markets.

## Market Structure and Practices

Capital markets in several Muslim countries do not have a good reputation among foreign investors. This low level of confidence stems from a number of practices that leave investors vulnerable to market abuses such as price manipulation, front running, insider trading, and blank selling. Regulators should take steps to restore the credibility of the markets and to ensure that the trading of securities takes place in a transparent fashion.

Further, the operation of markets should be reviewed with a view to complying with *Shari'ah* requirements. For example, the practice of short selling and maintaining margin accounts is not considered acceptable by some *Shari'ah* scholars. A system-wide procedure should be established to standardize these practices. In order to encourage foreign borrowers and to gain access to liquid markets in other Muslim countries, regulators should promote

the listing of Islamic securities issued by foreign member countries on their domestic exchanges.

### **Incentives to Promote Capital Markets**

For the further development of Islamic capital markets, policymakers should provide incentives for businesses and financial institutions to engage in Islamic instruments. These incentives can come in the form of tax breaks for the issuers and underwriters of Islamic securities. These could include, for example, a tax deduction for research and product-development expenses or for payments made on *sukuk* similar to the tax deduction of interest payments in the conventional system.

In the area of equity markets, policymakers should try to attract retail investors to participate in *Shari'ah*-compliant stocks. With the rapid development of Internet banking, policymakers can attract retail investors from different geographical areas, provided that the markets are liberalized and there are no unnecessary restrictions on foreign investors.

### **Developing Supporting Institutions**

Today's capital markets are supported by many institutions that perform critical functions for their smooth operation. These institutions include rating agencies, standard-setting agencies and industry associations. Some progress has been made in this respect with the establishment of institutions such as the International Islamic Financial Market (IIFM) and the International Islamic Rating Agency (IIRA). The IIFM acts as an industry association to promote cooperation among market players and with conventional financial institutions to further enhance the growth of new Islamic products and financial instruments. The IIRA was established to rate, evaluate and provide independent assessments and opinions on the likelihood of future losses by Islamic financial institutions as well as their products and services. Both of these institutions are based in Bahrain and focus on that market. However, similar institutions could and should be established in other Muslim countries to support local markets.

### **Financial Engineering**

Financial engineering has revolutionized the conventional capital markets. *Sukuk* are a good example of financial engineering and the further application of such techniques in the area of development of money and intra-bank markets should be encouraged. Money markets provide liquidity in the short term and support capital markets to focus on long-term capital needs. Another strong candidate for further growth is the development of mortgage-backed and asset-backed securities, where a pool of homogeneous assets is securitized.

### Role of *Shari'ah* Scholars

*Shari'ah* scholars can also play an important role. It is essential that multidisciplinary expertise, covering topics ranging from theological interpretation to financial structuring, be developed through knowledge-sharing, cross-training and acquiring an understanding of the functioning of markets. To stimulate cross-border activities in both primary and secondary markets, the acceptance of contracts across regions and across schools of thought and markets will also be helpful.

### ENDNOTES

1. Ernst & Young (2009).
2. Askari *et al.* (2009).
3. Marzban (2009).
4. Vogel and Hayes (1998).
5. Usmani (1999).
6. Bennett and Iqbal (2010).
7. Triple-A rated *sukuk* issuance has to date been dominated by only one issuer, the IDB.

## CHAPTER 10

# Non-bank Financial Intermediation

**T**he fundamental tenets of Islamic finance advocate economic development through risk sharing and entrepreneurship, by way of generating linkages between the real and financial sectors. In this respect, the role of non-bank financial institutions (NBFI) is arguably more critical in an Islamic economy than in a debt-based, conventional financial system. While Islamic NBFIs are experiencing rapid growth, much needs to be done to make this growth sustainable. Policymakers must create a level playing field for Islamic NBFIs by standardizing contracts and creating a regulatory space for them to operate in. For profit/loss-sharing transactions, regulators must ensure vigilant monitoring of business performance. Finally, the growth and development of Islamic NBFIs should be promoted to their full potential, in order to foster equitable economic growth, enhance general access to finance, and expand consumers' options for *Shari'ah*-compliant financing.

A role and scope of non-bank financial intermediation in modern economies is not formally defined in the financial literature. Broadly speaking, NBFIs mediate the transfer of funds between capital-surplus and capital-deficit economic agents, with their delivery channels ranging from informal money lenders to investment banking firms. While NBFIs perform many of the same functions as commercial banks—such as lending, resource mobilization, asset management, and financial advice—their distinguishing characteristic is that they do not accept or maintain deposit accounts. Thus, NBFIs include private-equity and venture-capital firms, leasing and factoring companies, sector-specific financiers, cooperatives, credit unions, microfinance institutions, and development-focused lending institutions.

There is strong evidence that such institutions are vital for an economy's growth and prosperous development. NBFIs complement traditional banking services by offering multiple and diversified services to mobilize capital. The growth of NBFIs such as mutual funds increases product options available for portfolio management, which enhances diversification and ensures efficient risk allocation in the economy. Additionally, these NBFIs provide consumers with longer-term investment opportunities than commercial bank deposits, thereby mobilizing the funds requisite for the development of



equity and corporate capital markets, mortgage-backed securities markets, leasing and factoring, and venture capital. NBFIs such as microfinance institutions expand access to finance for consumers who are either considered non-bankable, or pose risks that traditional banks are unable or unprepared to bear.

In a *Shari'ah*-based financial system, deposit taking on the basis of a predetermined rate of return is prohibited. Rather, bank-based financial intermediation is based on a principal-agent contract whereby the client becomes a partner of the bank, and shares in its profits and losses. If one were to define a non-bank financial institution as one that does not accept deposits, it could be argued that all forms of *Shari'ah*-based financial intermediation are “non-banking.” However, for this discussion, we will consider Islamic commercial and investment banks—although based on profit/loss sharing—as banking institutions, and consider the financial institutions described above as non-bank.

Moreover, for the purposes of this chapter, we will narrow the definition of NBFIs to exclude infrastructure and supporting institutions such as brokerage firms, and include institutions which either accept investors' funds on the liabilities side, or perform investment or lending on the assets side. In adopting this focused definition, it is possible to identify four classes of NBFIs as operating in the Islamic financial industry today. These comprise institutions engaged in (i) asset and fund management (for example, mutual, commodity, and leasing funds—discussed earlier); (ii) specialized sector finance companies (for example, mortgage, leasing, and *mudarabah* companies); (iii) development institutions (for example, multilateral and microfinance institutions); and (iv) *takaful* (Islamic insurance). Although, data on NBFIs is sparse, Table 10.1 shows the number of institutions and estimated assets under management as compiled from several sources.

**TABLE 10.1** Size of NBFI industry as of 2010

Institution Type	No. of Institutions	Assets Under Management (US\$ billion)
Islamic Funds*	698	82.6
<i>Mudarabah</i> Companies (Pakistan)	40	0.4
Mortgage Companies**	10	2.5
Microfinance Institutions***	126	0.197

\*IFIS

\*\*Data based on mortgage companies in the US and UK as of 2008. Size is determined from informal sources.

\*\*\*As of 2008. Karim, Tarazi and Reille (2008)

## **SPECIALIZED SECTOR FINANCE COMPANIES**

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Specialized sector finance companies include those catering to home and consumer financing demands using *ijarah* (leasing) and *murabahah* (cost-plus financing) contracts, or those providing working capital to industrial or agriculture sectors. The most common types are mortgage, *mudarabah*, and leasing companies.

### **Islamic Mortgage Companies**

Islamic mortgages made news in the US in 2001, when government-sponsored home-mortgage giant Freddie Mac agreed to underwrite and securitize Islamic mortgages. In 2007, Freddie Mac bought over US\$250 million in Islamic mortgages.<sup>1</sup> Given the growth and demand for Islamic mortgages and the booming real estate market in the US, several commercial banks such as Devon Bank and University Bank started to offer Islamic mortgages. The chances of success for the Islamic mortgage industry are bright in Western markets, where capital markets are relatively liquid, transparent, and regulated. In particular, there is great potential in North America, where there is a sizeable Muslim community in middle- and upper-class income brackets.

Islamic mortgage companies provide home buyers with *Shari'ah*-compliant options to purchase property. They typically target Muslim communities in Western countries with developed conventional mortgage markets, such as Canada, the United Kingdom and the United States. There are four models of Islamic mortgage currently in practice, as follows:

**Lease to Own** The first model is based on the *ijarah wa "qtinah"* (lease to own) contract, in which the mortgage company purchases the desired property from the builder or existing owner, rents or leases it to the home buyer for a specified period of time, and ultimately sells it to the home buyer for a predetermined residual value. This model is the closest to the structure of a conventional mortgage.

**Cost Plus Mark-up** The second model is based on the *murabahah* contract, in which the bank purchases the desired property from the builder or owner, and immediately sells it to the new home buyer at cost plus a predetermined profit. The buyer and the bank enter into an agreement where the buyer agrees to pay the financed amount over a predetermined period in pre-agreed installments. While, on the surface, this form of Islamic mortgage is similar to a conventional fixed-rate mortgage, there are some differences with respect to insurance obligations and in the way installment payments are treated for tax purposes. *Murabahah* mortgages are commonly practiced in the UK because until 2003 Islamic mortgages based on lease or equity partnerships were subject to double property-transfer tax laws.

The *murabahah* mortgage is often criticized on two grounds. First, a concern is raised that it is financially equivalent to a conventional debt-based mortgage and therefore does not involve risk sharing—the essence of Islamic finance. Second, this model suits well for fixed-rate mortgages but does not offer an option for a variable- or floating-rate mortgage.

**Diminishing Partnership** The third model is based on the diminishing *musharakah* (equity partnership) where the financier (the mortgage company or bank) and the buyer form an equity partnership to jointly own the property and the financier gives the buyer the option/right to buy the financier's share over the life of the mortgage. Over this period, the buyer pays monthly installments comprising the property's monthly rent and an additional contribution to buy out the mortgagee's share. Diminishing partnerships can take various forms and therefore offer flexibility in the design of the product. In a typical diminishing *musharakah* mortgage, the buyer pays the rent on the outstanding share owned by the mortgagee, which diminishes with the age of the mortgage.

For example, if at a given time during the life of the mortgage the ratio of ownership between buyer and mortgagee is 20:80, the buyer will pay monthly installments consisting of rent against 80 percent of the value of the house and the remaining portion will go towards the purchase of mortgagee's share. Suppose, after one installment, the new ownership ratio becomes 22:78, the rental portion of the next installment will decrease and the portion to purchase the mortgagee's share will increase. Thus, over time, the share of the mortgage will "diminish" and the buyer's share accelerates till the buyer owns the property entirely.

While an equity-based mortgage is closer to Islamic principles, it gives rise to concerns as to whether additional protection is needed for the owner. For example, as the market value of the property goes up, this will increase the period over which the owner will have to purchase the mortgagee's share. Ansar Finance in Manchester, UK, offers a variation on the diminishing *musharakah* mortgage whereby the client makes rental payments for the outstanding share without any obligation to purchase. The client is given an option to purchase the property at the market value, which protects the client from negative equity.<sup>2</sup>

**Cooperative Model** The fourth model is similar to a cooperative set-up. Members buy equity membership in a pool of funds used to purchase properties for the members.

### ***Mudarabah* Companies**

As we have seen, a *mudarabah* is a profit/loss-sharing contract in which one party serves as financier while the other apportions the financier's funds in *Shari'ah*-sanctioned business activities. A *mudarabah* company, therefore, is one which specializes in financing a portfolio of assets in selected economic

sectors, using its own capital and investors' funds, which are mobilized by issuing certificates or shares on a profit and loss basis. A *mudarabah* contract can be used for either multi-purpose or specific-purpose transactions. All *mudarabah* contracts are independent of one another, and no one transaction is liable for the liabilities of, or is entitled to benefit from the assets of, any other *mudarabah* transaction.

In 1980, Pakistan's State Bank issued a law under which financial institutions could register themselves as *mudarabah* companies and mobilize general investors' funds through issuing *mudarabah* certificates. The majority of Pakistan's "Modaraba Companies" (MCos) specialize in leasing, and are therefore also a valuable source of funding for small- and medium-sized enterprises for trade, commerce and fixed assets. By the late 1990s, 49 Pakistani companies had been granted licenses authorizing them to float *mudarabah* certificates.

However, the MCos have acquired a tarnished reputation, with a very small proportion of their funds purportedly being used for profit/loss-sharing transactions.<sup>3</sup> Regulatory mismanagement and a lack of rigorous screening of company listings have also resulted in losses to investors. This outcome has discouraged other countries from experimenting with *mudarabah* companies.

As a profit/loss-sharing commitment, a *mudarabah* gives preference to financially sound business ventures over mediocre ones, therefore facilitating enhanced resource management. If administered appropriately, *mudarabah* companies can serve as catalysts for economic growth in Islamic economies. In order to increase investor confidence, regulatory agencies must perform diligent screening and controls, and require *mudarabah* companies to enhance transparency and operational efficiency.

### **Specialized Leasing Companies**

Leasing is becoming increasingly popular as a form of asset financing. Traditionally, leasing services—whether conventional or Islamic—have been provided by commercial banks. In recent years, the growth and development of specialized Islamic leasing companies has paralleled the rise of their conventional counterparts.

Islamic leasing is more commonly used for real estate and automobiles, but equipment leasing is also growing. Leasing companies typically use an *ijarah* contract, in which the ownership of the asset, associated risk, and responsibility for its maintenance remains strictly with the leasing company. The company is typically not the original owner of the asset, but acquires it at the request of the client. At the end of the leasing term, the institution may sell the asset to the client. For the leasing of equipment, some companies, particularly in the Gulf States, use *murabahah*, where ownership of the asset is immediately transferred to the lessee, and the leasing company does not retain any rights to sell or transfer the asset.

Leasing enables businesses to employ a range of capital goods without having to purchase them. Therefore, it can both promote economic

stimulation and, at the same time, provide the leasing company with an attractive flow of fixed monthly income. Given this asset-backed *modus operandi*, leasing companies play an important role in strengthening linkages between the financial and real sectors of an economy. Since the workings of Islamic forms of leasing are similar to those of interest-based models, Islamic leasing companies have enormous potential to tap both markets. A key concern which leasing companies must grapple with is developing liquidity for leased assets, or for the financial claims created as a result of leasing. With proper management, lease securitization can play a leading role in enhancing the liquidity status of these companies.

### **Microfinance Institutions<sup>4</sup>**

It is clear that within the present dominant economic system there are a number of serious market failures that cannot be resolved without external intervention. One such failure is the inability of the prevailing credit system to satisfy loan demands from segments of the population that cannot access formal credit channels or do not have sufficient collateral against which they can borrow. These “non-banked” or “non-bankable” groups include not just the poor; would-be entrepreneurs with projects or ideas with potentially high rates of return also fall within this category.

A solution to this market failure came in the form of the Grameen Bank, which has been a phenomenal success since its inception in the mid-1970s. Information economics, developed by Joseph Stiglitz, explains that informational problems underlie many failures of the market system. In particular, the failure of credit markets is due to the fact that the collection and analysis of information is a high-cost activity for financial intermediaries (such as banks), making it expensive to decide whether to extend a loan, and then monitor the behavior of the borrower to ensure compliance with the loan’s terms and conditions as well as its repayment. If information costs are too high, banks extend loans only to those clients with a good credit record and/or high-valued collateral to make defaults costly. Underlying this is the notion of asymmetric information, that the borrower may have information regarding the project’s purpose and chances of success that the lender lacks. This may lead to the lender extending loans to risky borrowers willing to pay high interest rates, or to moral hazard problems where the borrower will use the proceeds for purposes other than those stated or with the intention of defaulting.

Microfinance (MF) gets around these problems by resorting to group lending. In its original conception (Grameen I), no collateral was required and only the poor could borrow, but each client had to be a member of a five-person group which, in turn, belonged to an eight group “center” within a village. While the loans would be granted to individuals within the group for their own independent projects, failure to repay the loan would lead to collective punishment: the entire five-member group would lose its membership in the bank. While there was no explicit requirement for the group to pay off a loan default by one of its members, implicitly there was a strong

incentive for the group to do so if it wanted to regain its membership. The interest rates of MF banks have been in the order of 20 to 30 percent.

This approach to lending to a close-knit group of borrowers resolves both informational problems of adverse selection and moral hazard by shifting the cost of *ex ante* selection of the right borrowers (those with a low probability of default) and the responsibility for monitoring the borrower's behavior to the group. The track record of high repayment rates documents the success of this approach. While Grameen II has modified some of the features of its predecessor, it has retained the basic structure of the earlier version in that reliance is still placed on the reputation of borrowers with group familiarity with each client, interest rates are still as high as 30 percent, and the eventual aim of these institutions is to become successful profit-making banks.

Microfinance and Islamic finance share common ideas and values. Islam's emphasis on economic and social justice through financial inclusion and risk sharing is the foundation for Islamic microfinance. As Islamic finance is establishing itself, attempts have been made to establish *Shari'ah*-compliant microfinance institutions. Modern Islamic microfinance lending has trailed the advance of the conventional microfinance movement. Since the 1970s, a number of institutions have entered the market to service the demand of poor Muslims who refuse financing instruments that contravene *Shari'ah* principles. Islamic microfinance institutions include non-governmental organizations (NGOs), rural cooperatives, credit unions, self-help schemes, and *qard-ul-hassan* funds. In addition, some conventional NGOs operating in Muslim communities have Islamic windows, and offer *Shari'ah*-compliant products among their financing options.

**NGO-based Microfinance** Microfinance NGOs pursue the dual objectives of social and financial returns. They are concerned with providing financial services to those individuals who are too poor to offer sufficient collateral to conventional banks. Many NGOs offer vocational training to their clients, or advise clients on investment decisions. However, loans are not typically disbursed as charity. Most NGOs aim to become sustainable lending institutions, seeking timely payments and high repayment rates, and instilling fiscal discipline in their borrowers. Some NGOs use group-lending methodologies, in which borrowers come together as a group and serve as guarantors for one another in the event of default. An overwhelming majority of Islamic microfinance NGOs use *murabahah* (cost-plus financing) as their primary product. Other contracts include *ijarah* (leasing) and *takaful* (mutual insurance). Deposit-taking restrictions imposed on non-licensed institutions mean that microfinance NGOs are unable to offer savings products such as *musharakah* and *mudarabah*. Today, a majority of NGOs engaged in *Shari'ah*-compliant microfinance remain dependent on donor funds.

**Islamic Microfinance Cooperatives** Islamic cooperatives are community-based organizations designed to mobilize deposits from member clients and use

these funds to provide productive, consumer, and social loans to their members. They are often supported by personalities and organizations that exert a strong religious and social influence on the community. In Indonesia, a network of approximately 4,500 cooperatives offer savings products based on *mudharabah* and *musharakah*, and financing based on *murabahah*, *mudharabah*, and *qard-ul-hassan* contracts. However, a majority of these cooperatives have either gone bankrupt or lie dormant (Seibel 2007).

Syria's Islamic cooperatives or "Village Banks" have been quite successful. They are financed through members' share capital, run by elected members, and offer only *murabahah* financing. Returns are shared among members based on *musharakah* principles, or are retained as capital. Rahman and Ahmad (2010) examine a *Shari'ah*-compliant microfinance scheme in Bangladesh and show that household income increased significantly as a consequence of the program. Islami Bank Bangladesh Limited (IBBL) launched a rural development scheme (RDS) aimed at alleviating rural poverty in 1995. This *Shari'ah*-based microfinance program provides welfare, moral, and ethical services to the rural population in 60 districts. Of the membership of more than half a million, some 94 percent are women. The RDS practices *murabahah* and *bay' al-muajjal* contracts to purchase goods and sell them to the clients at a flat profit rate of 10 percent, with a rebate of 2.5 percent for timely payment. This compares with conventional microcredit, which charges 15–22 percent interest. It is claimed that the investment recovery rate of the RDS is 99.57 percent.

**Credit Union-style Microfinance** Another Islamic microfinance model is based on the concept of mutuality and is similar to a conventional credit union (CU). A CU is a non-profit financial cooperative owned and controlled by its members and engaged in mobilizing savings, offering loans to its members who have a common goal or objective. CUs are quite popular in Asia, notably in Sri Lanka.<sup>5</sup>

***Qard-ul-hassan*-based Microfinance** *Qard-ul-hassan* funds are socially oriented organizations which provide community members with interest-free loans. A *qard-ul-hassan* (benevolent loan) is the only type of loan permitted under the *Shari'ah*. It is often considered a form of charity, because the lender is encouraged to forgive borrowers if they default and repayment is a financial burden on them. According to the Central Bank of Iran's March 2008 estimates, Iran's 6,000 *qard-ul-hassan* funds had a total of US\$5.5 billion in outstanding loans. Since these institutions are heavily reliant on donor funds, they are unsustainable in the long run (Karim *et al.* 2008).

The scope, scale, and product portfolio of each type of institution differs from the next. Nonetheless, there are some discernable trends. A vast majority of Islamic microfinance institutions cater to a higher percentage of women than men, use *murabahah* as the predominant financing instrument, and have far lower outreach than their conventional counterparts operating

in the same regions. Total Islamic microfinance outreach is estimated at 380,000 customers worldwide (Karim *et al.* 2008).

There is a growing realization that Islamic microfinance is essential for those Muslim countries where increasing numbers of the community are suffering from poverty and are in dire need of access to low-cost financing. Much needs to be done and efforts are required to promote *Shari'ah*-compliant microfinance in both public and private sectors. Keeping this in mind, the Islamic Development Bank (IDB) recommends several steps at micro, meso, and macro levels to further promote *Shari'ah*-compliant microfinance (see box).

Banking the non-bankable was the idea behind the establishment of microfinance institutions. However, over the years, conventional microfinance based on the Grameen model has witnessed a paradigm shift. For years, the concept of microfinance was considered a domain for NGOs but, given its success rate, the private sector is now viewing this as purely a commercial proposition and an opportunity to introduce a market-based solution. This should be encouraging for Islamic banks and financial institutions to consider this as an untapped market and to introduce financial products geared specifically for this segment.

### **RECOMMENDED ISDB INTERVENTION IN PROMOTING ISLAMIC MICROFINANCE**

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#### **At a micro level**

- Participate in equity of Islamic financial institutions with a view to creating specialized MF Divisions
- Create specific funds to support various *qard-ul-hassan*-based microfinance institutions across the globe
- Create a refinance facility to act as a wholesaler of Islamic microfinance products for a chain of Islamic and conventional microfinance retailers
- Participate in equity of commercial *takaful* companies with a view to developing micro-*takaful* products and services; also of re-*takaful* companies (discussed later)
- Design a credit-guarantee scheme for Islamic microfinance providers
- Promote dialogue among *Shari'ah* scholars for collective resolution of *fiqhi* issues related to microfinance

(Continued)



### At a meso level

- Develop knowledge base through research in issues pertaining to building
- Islamic inclusive financial systems
- Document, collate and translate best practices from microfinance across the world; undertake training and education programs to impart microfinance-related special skills to bankers
- Undertake training of trainers to impart managerial and accounting skills to users of microfinance
- Encourage formation of apex and regional industry associations whose objective is the development of Islamic microfinance through human resource development, technical assistance, operational standardization and financial product development, facilitation of vertical and horizontal communication among Islamic financial institutions, advocacy and participation in policy dialogue
- Create *zakah* and *awqaf* funds at a global level dedicated exclusively to poverty alleviation and linked to microfinance institutions downstream
- Help create a rating mechanism in member countries for Islamic microfinance institutions.

### At a macro level

- Assist member countries to develop a regulatory framework for Islamic microfinance
- Support policymakers to ensure that there is an enabling policy framework conducive to the development of Islamic microfinance
- Support and facilitate the integration of *zakah* and *awqaf* in financial-sector reforms
- Build an effective alliance and forum of Islamic microfinance providers and other stakeholders.

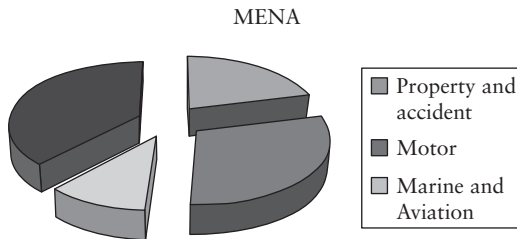
Source: Islamic Microfinance Development: Challenges and Initiatives, 2008, IRTI, IDB

### **Takaful (Islamic Insurance)**

The closest Islamic instrument to the contemporary system of insurance is the instrument of *takaful*, which literally means “mutual or joint guarantee.” Historically, demand for insurance products has been much lower in Muslim communities than in conventional markets such as North America

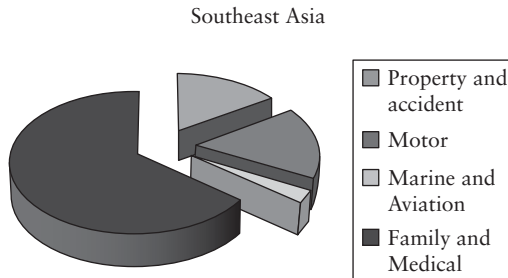
and Western Europe. This can be attributed to the fact that the conventional insurance industry indulges in the prohibited elements of interest and gambling. However, with the introduction of an Islamic mode of insurance, more and more Muslims are open to the idea.

At present, *takaful* has very limited application in Islamic financial markets, with very few institutions offering insurance services on a large scale. Although, the application of *takaful* is for the most part indemnity-based and limited to the loss of physical property, there are products in the market targeting family and medical coverage based on *Shari'ah* principles. According to some estimates, the global *takaful* industry has grown from US\$1.4 billion in 2004 to around US\$5.3 billion in 2008 (2010 forecast US\$8.9 billion), which is considered significantly below its true potential.<sup>6</sup> It is estimated that the market now comprises more than 130 companies in both Muslim and non-Muslim (including Western) countries. In several economies where Islamic finance is practiced, *takaful* is offering price-competitive products and has captured significant proportions of non-Muslim customers.<sup>7</sup> Figures 10.1 and 10.2 show how the coverage was distributed among different sectors in the Middle East and North Africa (MENA) and Southeast Asia regions during 2007. The greater prominence of family and medical insurance in Southeast Asia could be attributed to the popularity of *takaful* in Malaysia.



**FIGURE 10.1** *Takaful* market segments in MENA region

Source: E&Y (2010)



**FIGURE 10.2** *Takaful* market segments in Southeast Asia region

Source: E&Y (2010)

## TRENDS IN THE *TAKAFUL* MARKET

- The Gulf Co-operation Council (GCC) region remains one of the strongholds for *takaful*, with a total volume exceeding US\$3.7 billion in 2008 and accounting for more than half of the global *takaful* market for that year (US\$5.3 billion).
- In Southeast Asia, Malaysia holds the strongest position in volume of *takaful* contributions, which stood at US\$889 million in 2008. Indeed, the country is a glowing example of how *takaful* is part of the financial awareness of customers: some banks report a share of non-Muslim *takaful* customers of over 50 percent and in some cases, over 70 percent, a sign of the successful integration of *takaful* in Malaysia.
- The number of *takaful* operators globally grew from 133 in 2007 to 179 within a year. For such a nascent industry, it has shown no signs of abating and quite a strong resilience demonstrated by a net contributions growth of 18 percent for Malaysia and gross premium growth of 28 percent for Saudi Arabia in 2008, a stark contrast with the conventional sector (with an average of 2.5 percent). In the GCC, Saudi Arabia is a flagship market for *takaful* and witnessed strong growth in 2008. Gross written premiums reached SAR10.9 billion (US\$2.9 billion), up from SAR8.6 billion (US\$2.29 billion) in 2007, representing an increase of 27 percent, compared to 24 percent in 2007. Fifty-one percent of those premiums generated stem from general insurance (a growth of 6.3 percent to SAR5.5 billion (US\$1.46 billion) in 2008 compared to SAR5.2 billion (US\$1.38 billion) in 2007), 44 percent comes from health insurance [a growth of 57 percent to SAR4.8 billion (US\$1.27 billion) in 2008 compared to SAR3.1 billion (US\$826 million) in 2007] and the rest comes from life *takaful*.
- One of the positive trends in this market is that recently there is an increasing number of joint ventures between local and international financial institutions. For example, in November 2008, Zurich Financial Services signed an agreement to establish a joint venture with Abu Dhabi National Takaful. In June 2009, AXA announced its partnership with Salama in the UAE. In Saudi Arabia, FWU Group, the global *takaful* provider, has a stake in Al Ahli Takaful Company and has forged successful distribution partnerships, such as with National Commercial Bank. FWU Group also enjoys a very successful partnership with AMAN, based in Dubai. In November 2009, Allianz Takaful and Standard Chartered Bank announced a five-year sales agreement to promote insurance products from Allianz Takaful in Bahrain. Allianz has received

authorization to operate in Qatar and hopes to launch its first Islamic annuity product in the course of this year, tapping into a growing number of clients in the Middle East keen to add to their state pensions. In December 2009, Generali, the Italian insurance giant, announced it was entering into a strategic partnership with Qatar Islamic Bank in order to access the GCC *takaful* market.

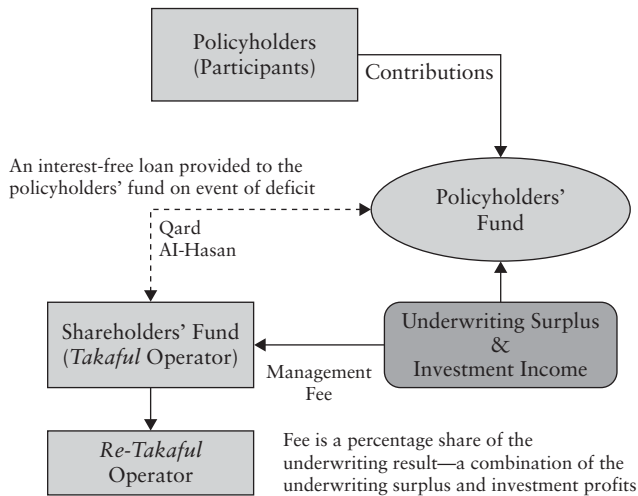
- To raise the awareness of *takaful* and to promote full transparency, consumer education is also extremely important. In Europe, CIMA (Chartered Institute of Management Accountants, based in the UK) as well as the Universités de Dauphine and Strasbourg have added Islamic Finance, including *takaful*, to their curriculum. To achieve this, Bank Negara Malaysia has launched an initiative called “insurance info” which is basically the Consumer Education Program (CEP) on insurance and *takaful*. A joint effort between the banks, the insurance and the *takaful* industry, the program is designed to provide educational information to enable consumers to make well-informed decisions when purchasing.

Source: Jaffer (2010a) and (2010b)

There is no standard operating model for *takaful* companies, as each country may decide on a particular model. Primarily, *takaful* models can be *mudarabah*-based, *wikala*-based or a hybrid of the two.

Typically, implementation of *takaful* is carried out in the form of solidarity *mudarabah*, where the participants agree to share their losses by contributing periodic premiums in the form of investments. They are then entitled to redeem the residual value of profits after fulfilling the claims and premiums.<sup>8</sup> One of the critical differences between contemporary insurance models and *takaful* is the participant’s right to receive surplus profits. While the participants in a given *takaful mudarabah* have the right to share the surplus profits generated, at the same time they are liable for additional amounts if the initial premiums paid during a period are not sufficient to meet all the losses and risks incurred during that period. *Takaful* companies can constitute reserves (like conventional mutual insurance companies), which allow the need for the insured to make supplemental contributions if claims exceed premiums. Figure 10.3 shows a *takaful* set-up based on a *mudarabah* contract, the workings of which can be summarized as follows:

- A principal/agent agreement is established between the insurance operator (agent/manager) and the policyholders (principal) where policyholders are *rabb-al-mal* and insurance operator is *mudarib* to perform both asset management and underwriting.



**FIGURE 10.3** *Mudarabah-based takaful model*

Source: E&Y (2009)

- The operator puts up equity capital and undertakes responsibility to manage the investment fund consisting of policyholders' premiums in accordance with *Shari'ah* principles. The operator also agrees to run the insurance operations of the *takaful* business on behalf of the policyholders.
- The shareholders (the operator) are paid a pre-agreed proportion of any surplus generated by the policyholders' funds. If the fund makes a loss (the claims exceed the premiums), the operator may provide an interest-free loan to cover losses.
- The *takaful* company accepts premiums from the insured. As in conventional insurance, the insured pays premiums to the operator based on the probability of losses and, in exchange, receives the defined protection against future losses.

In the *wikala* model, the policyholders and the *takaful* operator enter into a principal (policyholder) and agent (operator) agreement whereby the operator becomes the representative (*wakil*) of the policyholders. The operator is paid an agreed fee to operate and manage the policyholders' assets. Technically, there is not much difference between the *mudarabah*-based or *wikala*-based models except that the underwriting surplus goes back to the policyholders' funds, rather than being shared with the shareholders or operator.

In the third, hybrid, model the *wikala* agreement is utilized for underwriting activities and to run the operation, while the *mudarabah* contract is

used for asset-management purposes. In this case, the asset management business can be run by an entirely different entity—that is, a professional asset manager—on behalf of the policyholders. Some regulators may prefer this model for transparency reasons. For example, the Central Bank of Bahrain prefers this model.<sup>9</sup>

### **Distinctive Features of *Takaful***

**Cooperative Organization** *Takaful* is based on principles of mutual assistance and therefore is similar to conventional cooperative insurance whereby participants pool their funds together to insure one another. The customers (policyholders) of the *takaful* business agree to pool their contributions and share the liability of each. Claims are paid out of the combined pool of contributions and assets.

**Risk Sharing** In the risk-sharing aspect, the *takaful* is closer to the essence of Islamic finance than the Islamic banks. The policyholders share in the profits and losses of the business through sharing each other's insurance risk as compared to conventional insurance, where there is no sharing of risks across policyholders. For example, in the case of a typical *takaful* model, a surplus or profit made at the end of a financial year after satisfying all claims and reserves is shared between the *takaful* operators and its policyholders. On the other hand, if at the end of the financial year the policyholders' fund suffers a loss, the deficit is funded by an interest-free loan (*qard-ul-hassan*) from the shareholders' fund. Any future surpluses are used to repay the loan. The shareholders' access to the capital from the fund is restricted until the loan is repaid.

**Shari'ah-compliant Investments** One of the most distinguishing features of *takaful* is the requirement that all investments and assets under management are invested in accordance with the principles of Islam and therefore have to be fully compliant with *Shari'ah*. Where conventional insurance companies invest funds in debt-based fixed-income securities, derivatives, government securities, and hedge funds, a *takaful* asset manager cannot invest in these products. Similarly, any investment in stock markets is required to be compliant with *Shari'ah*. With the continued expansion of Islamic financial markets, there are more opportunities of *Shari'ah*-compliant investment products and this requirement is becoming much less of a constraint.

**Mutual Guarantee** *Takaful* is based on cooperative principles which spread the liability amongst the policyholders and all losses are shared. This mutuality results in the policyholders guaranteeing the performance of each other. In other words, policyholders are both the insurer and the insured.

Table 10.2 provides a comparison of different features of *takaful*, conventional, and mutual insurance.

**TABLE 10.2** Comparative features of *takaful*, conventional and mutual insurance

	Conventional insurance	Mutual insurance	Takaful
Responsibility for providing protection	Risk is transferred from the insured to the insurer	Mutual risk sharing among members	Mutual risk sharing amongst participants
Governing law	Secular law and regulation	Secular law and regulation	Secular law and regulation and <i>Shari'ah</i> law
Ownership	Shareholders of insurance company	Members	Participants
Contract forms	Bilateral insurance policy	Bilateral insurance policy	<i>Wikalalmudarabah</i> agreement and unilateral contracts based on principles of <i>tabarru</i> (donation)
Investment	No restrictions on equity/debt investments	No restrictions on equity/debt investments	All investments to be in accordance with <i>Shari'ah</i> principles—excludes all debt and some equity investments
Liability of the operator	The insurance company (and ultimately its shareholders) are responsible for any claims payments	The members of the mutual are collectively responsible for the payment of claims and may be asked to contribute in the event of shortfall	The participants are collectively responsible for the payment of claims and may be asked to contribute in the event of shortfall if the <i>takaful</i> operator does not provide <i>qard-ul-hassan</i> (interest-free loan)
Surplus in operational income	Ultimately for account of shareholders	For account of members	For account of participants

Source: Hodgins (2009)

## Issues and Challenges for the *Takaful* Industry

The *takaful* industry is growing fast and it is expected to grow even further. Features of *takaful* are attractive not only to those who wish to comply with *Shari'ah* but are equally attractive to conventional customers who are attracted to the cooperative and ethical nature of *takaful*. As with any emerging market, the industry faces several challenges, some of which are common to the Islamic financial industry as a whole. These include a lack of financial engineering, a shortage of human resources, an inadequate risk-management framework, and a lack of liquidity. However, there are several industry-specific challenges, as discussed below.

- Reinsurance plays a critical role in the conventional insurance industry in that it allows insurance companies to protect themselves against excessive risk and to spread risk across the industry. There is no such facility for the *takaful*, which has limited the opportunity to expand the business. *Shari'ah* rules make it difficult for *takaful* operators to utilize conventional reinsurers. While in some cases *Shari'ah* scholars have allowed the use of conventional reinsurers, it is not a preferred option.
- Global brands such as Munich Re, Hannover Re and Swiss Re, together with regional players like Takaful Re and MNRB Retakaful, have contributed to enhancing the Islamic reinsurance capabilities. Today, there are nine fully fledged re-*takaful* operators, mostly in Malaysia, which is widely acknowledged as being at the forefront of regulations for the industry. Indeed, the Southeast Asian model is widely considered to be a blueprint for all insurers—local operators and international players alike—who have the desire to explore *takaful* (Jaffer 2010a).
- The success of the *takaful* business is dependent on its asset-management skills and therefore requires typical financial products and tools to construct and manage efficient portfolios. In this respect, the lack of short-term *Shari'ah*-compliant instruments and the lack of liquidity in the market pose serious challenges for *takaful* operators. The issue of liquidity needs to be addressed for the benefit of the Islamic finance industry as a whole. Without the tools to manage portfolios against market and liquidity risks, operators cannot offer competitive products in the market.
- The *takaful* industry is comparatively new among other Islamic financial services. It faces several challenges in gaining entry to markets in which the regulatory and supervisory environment favors conventional insurance business but is not very well suited for *takaful*. In relation to financial reporting standards, both AAOIFI and IFSB have helped by defining the industry standards necessary to promote this business in countries interested in expanding this sector.
- As mentioned earlier, *takaful* products have been primarily geared towards property insurance, and growth in the area of life insurance has been slow because of continuing suspicions that it may entail an



element of gambling. While *Shari'ah* scholars are still divided on the issue, growing numbers are turning in favor of life insurance. *Takaful* companies need to educate their potential customers well with regard to *Shari'ah*-related issues, taking care not to deliver this education in a way that can be perceived as marketing or advertising. Similarly, they need to educate conventional customers about the benefits of *takaful* to attract their business.

## ENDNOTES

1. Aizenman (2008).
2. Gassner (2009).
3. Dar and Presley (2000).
4. See Iqbal and Karim (2010) and Askari *et al.* (2008).
5. See Obaidullah and Abdul Latiff (2008).
6. Ernst & Young (2010).
7. PriceWaterhouseCoopers (2008).
8. For instance, under the Malaysian *Takaful* Act 1984, the legal definition of a *takaful* scheme is based on the concept of solidarity and brotherhood, which provides mutual financial aid and assistance to the participants in cases of need, whereby the participants agree mutually to contribute for that purpose.
9. Ernst & Young (2009).

## CHAPTER 11

# Performance of Islamic Financial Services

**W**ith the expansion of the market for Islamic financial services, questions began to be asked about the efficiency and cost-effectiveness of such services vis-à-vis their conventional counterparts. Early comparative studies focused on Islamic and conventional banks within the same country or region. Gradually, these were extended across regions. As capital markets grew, the focus shifted to the financial performance of Islamic funds relative to Islamic indices.

### **THE EFFICIENCY OF ISLAMIC BANKS**

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A typical measure of efficiency is the ability to convert inputs (staff costs, fixed assets and total deposits) into outputs (total loans, liquid assets and other income). Several studies have been undertaken to evaluate the cost and production efficiency of Islamic financial institutions in different countries where Islamic finance is practiced. The majority of such studies have measured efficiency using accounting ratios, comparing them with the ratios of conventional banks of similar size and location.

Metwally (1997) compared the performance of 15 interest-free banks with 15 conventional banks for structural differences between the two groups in respect of liquidity, leverage, credit risk, profit, and efficiency. The study found that although profitability and efficiency differences were not statistically significant, Islamic banks tended to be more conservative in utilizing funds for lending and were disadvantaged in their investment opportunities. Similar findings of constrained investment opportunities were observed by Samad and Hassan (1999), who looked at the interbank performance of Bank Islam Malaysia Berhad (BIMB) in terms of profitability, liquidity, risk, and solvency as well as community involvement for the period 1984–97. They concluded that the average profit of an Islamic bank was significantly lower than that of the conventional banks, mainly because of the limited investment opportunities.

Iqbal (2000) measured the efficiency of 12 Islamic banks by comparing their trends and profitability ratios with a “control group” of 12 conventional banks of similar size from the same countries. The Islamic banks studied accounted for more than 75 percent of the total assets as well as the total capital of the whole Islamic banking industry and were thus reasonably representative of the entire sector. The study found that during the period 1990–97, Islamic banks achieved higher rates of growth in total investments, total assets, total equity, and total deposits than their conventional counterparts. More importantly, it found that Islamic banks also turned out to be more cost effective and made better use of their resources than the banks in the control group, as indicated by their significantly higher deployment ratios.

Hassan and Bashir (2003)<sup>1</sup> analyzed how bank characteristics and the overall financial environment affect the performance of Islamic banks. Utilizing bank-level data, the study examined the performance indicators of Islamic banks worldwide during the period 1994–2001. First, the banks’ profitability measures responded positively to increases in capital and negatively to loan ratios. The results revealed that a larger equity-to-total-asset ratio led to greater profit margins. This finding was intuitive and consistent with previous studies. It indicated that adequate capital ratios play a weak empirical role in explaining the performance of Islamic banks. The Islamic banks’ loan portfolio was heavily biased towards short-term trade financing. As such, their loans were low-risk and only contributed modestly to profits. Bank regulators may use this as evidence for the need for prompt supervisory action. Second, the results also indicated the importance of consumer and short-term funding, non-interest-earning assets and overheads in promoting bank profits. Third, the results suggested that the regulatory tax factors are important in the determination of bank performance.

Based on data from 1993 to 2000, Majid, Nor and Said (2003) concluded that there was no statistically significant difference in the level of efficiency between Islamic and conventional banks operating in Malaysia. This study did, however, find a linkage between inefficiency and size. The size of the bank not only influenced inefficiency, it also did so in a non-linear fashion. Increasing size initially provided some economies of scale; however, diseconomies of scale set in once a critical size was reached, thus suggesting a U-shaped average cost function. Hussein (2003) estimated the operational efficiency of 17 Sudanese Islamic banks from 1990–2000 and found that these did not create inefficiency per se, but that there were wide efficiency differences across domestic Islamic banks. However, foreign banks were found to be more efficient, despite their small size, than the state-owned and joint-ownership banks.

Brown and Skully (2005) examined the efficiency of 36 Islamic banks across 19 countries. They found that average cost-efficiencies based on International Accounting Standards were 46.4 percent, 80.8 percent, and 89.7 percent in Africa, Asia, and the Middle East, respectively. However, based on International Financial Reporting, the results were 45.9 percent, 66.5 percent, and 66.5 percent. Their results also showed that where Iran had the largest

banking market, Saudi Arabia had the highest equity ratio. The highest net interest margin and the highest returns on adjusted assets (ROAA) were in Bahrain and the highest return on adjusted equity (ROAE) was in Gambia. At the regional level, Islamic banks from the Middle East were the most efficient, followed by Asia and Africa.

Yudistira (2004) provided evidence on the performance of 18 Islamic banks over the period 1997–2000. Overall, the results suggested that Islamic banks suffered slight inefficiencies during the Asian crisis of 1998–99. Efficiency differences across the sample data appeared to be mainly determined by country-specific factors. Islamic banks showed considerable overall efficiency across the sample period, with the year 2000 being the most efficient year. However, it is interesting to note that the Islamic banking industry experienced slight inefficiencies in 1998 and 1999 (0.870 and 0.897, respectively) compared to 1997 and 2000 (0.902 and 0.909, respectively). Islamic banks in the Middle East region performed better in overall technical efficiency until 1998 but subsequently recorded sluggish results compared to their counterparts elsewhere. The explanation for this is that Islamic banks outside the Middle East region, especially those in the East Asia region, experienced greater difficulty in the Asian economic crisis in 1997–98. However, when most economies slowly recovered from the crisis (from 1998 onwards), non-Middle East Islamic banks became slightly more efficient than their Middle East counterparts. Previous studies have argued that the explanation lies on the depositors' flight to quality, which was found mainly in the East Asia region. To analyze the size–efficiency relationship, Islamic banks across the sample were grouped by total assets in which banks with more than US\$600 million of assets were categorized as “large” and banks below this level were categorized as “small-to-medium” size. Concentrating on scale efficiency (SCALE), it is clear that the largest degrees of scale inefficiencies came from large Islamic Banks, with the lowest SCALE score being 0.915 in 1998. It is interesting to note that all but one of the large Islamic banks exhibited decreasing returns in 1997–98, whilst in 1999–2000 most showed constant returns to scale.

Bader *et al.* (2007) explored the cost, revenue, and profit efficiencies of 43 Islamic and 37 conventional banks in 21 countries in Africa, Asia, and the Middle East, using financial ratios for the period 1990–2005. Efficiency was measured based on different sizes and ages of banks and their locations. The findings showed no significant differences in efficiency scores between them. On average, the larger the size of total assets, the higher the efficiency and, surprisingly, the revenue and profit efficiency scores for old banks were lower than for new banks.

This research found no significant difference in the mean scores between big and small banks for all efficiency categories. Therefore, any claims that the cost, revenue, and profit efficiency of big banks are significantly better than those of small banks cannot be accepted. This evidence suggests that size does not affect cost, revenue and profit efficiency. The findings also disprove the claims that the mean cost efficiency of new conventional banks

is significantly higher than that of new Islamic banks. In fact, the revenue efficiency in a new conventional bank is significantly higher than that in a new Islamic bank. However, the mean revenue (and profit) efficiency of old conventional banks is not significantly higher than that of old Islamic banks.

The study compares the cost, revenue and profit-efficiency ratios of conventional and Islamic banks in Africa, Asia, and the Middle East and Turkey and does not find any significant differences across regions.

In 2008, IMF staff conducted a first-of-its-kind empirical analysis of the impact of Islamic banks on financial stability.<sup>2</sup> Using z-scores as a measure of stability, Cihák and Hesse (2008) found that small Islamic banks tend to be stronger financially than small conventional commercial banks; large conventional commercial banks tend to be stronger financially than large Islamic banks; and small Islamic banks tend to be stronger financially than large Islamic banks. The study speculates that the reason why Islamic banks, while more stable when operating on a small scale, are less stable when operating on a large scale could be that it is significantly more complex for Islamic banks to adjust their credit-risk monitoring system as they become bigger. The study suggests that monitoring the various profit-loss arrangements becomes rapidly much more complex as the scale of the banking operation grows, resulting in problems relating to adverse selection and moral hazard becoming more prominent.

In general, studies have found Islamic banks to be performing efficiently when compared with similar conventional financial institutions in similar market conditions. By international standards, the average size of an Islamic bank is relatively small but, despite this fact, it is surprising that no study has been able to provide convincing evidence of inefficiencies in Islamic banks. There could be two possible explanations as to why Islamic banks are found to be efficient irrespective of their small size. First, most of the studies have been performed as a comparison with conventional banks in the same geographical region; thus ignoring the impact of systemic inefficiencies. A more realistic analysis should include comparison of efficiencies against international benchmarks, comparison with foreign banks, controlling for any protection against competition, and should take into account the quality of standards, and other macroeconomic variables such as capital movement. Further, most of the studies were conducted during a period of high growth resulting from high demand for Islamic financial services. During the periods of high growth and demand, institutions are often subject to low levels of market pressure and competition. When institutions are entering into a niche market like Islamic finance, some level of inefficiency is compensated by the abnormal initial profit margins. These margins erode fast as more players enter the market and it becomes more competitive.

Another reason could be that undertaking an empirical study to review the performance of Islamic banks or to understand the efficiency of financial services is itself a challenge because of the low degree of transparency and quality of information disclosure. For instance, many Islamic banks do not provide sufficient details as to the division of equity and deposits. Further,

access to transaction-level data is extremely difficult. When it comes to deposits, it is hard to get any reliable and detailed breakdown of the deposit types offered by these institutions because of the common practice of “clubbing” different types of deposits together. Similarly, details on the assets side are often not very transparent. The above factors imply that the results of these efficiency studies are to be taken with caution and one cannot conclude that there is no need to improve efficiency.

## **PERFORMANCE OF ISLAMIC CAPITAL MARKETS**

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In 1998, the FTSE Group launched the first series of Islamic equity indices, the FTSE Global Islamic Index Series (GIIS). The GIIS is a subset of the FTSE All-World Index group, which includes stocks from 29 countries. The FTSE has 15 Islamic indices; classification is based on industry (10 indices) and region (Global, Americas, Europe, Pacific Basin, South Africa). This was followed by the first Dow Jones Islamic Market Index (DJIMI) in 1999, which was created to track the performance of companies whose activities are consistent with *Shari'ah* principles. More recently, Standard & Poor's has also introduced similar indices. The performance of all these indices is regularly monitored and reported.

When the idea of Islamic equity portfolios with special screens was developed, critics objected that by imposing such screens investors would be constrained, and have limited diversification benefits. However, this has been proven wrong, both theoretically and empirically. Lightstone (2006) argued that quantitative methods of stock selection are well suited to the selection of active Islamic strategies that track established equity styles and which can be evaluated against their benchmarks. The paper claimed that using quantitative analysis to develop portfolio strategies using Islamic screening rules strongly outperformed conventional benchmarks in 20 years of back-testing in up and down markets. The paper showed that given the availability of these strategies, there are now opportunities for asset allocation and style rotation.

Several empirical studies have looked at the efficiency and performance of the Islamic indices. Hussein (2005) undertook a comparison of the performance of the Dow Jones Islamic Index and the FTSE Global Islamic Index with those of the Dow Jones World Index and the FTSE All-World Index, respectively. The study reviewed the returns over different periods to control for behavior in different market conditions. The period from December 1993 to December 2004 was further divided into a bull period (December 1993 to December 2000), a bear period (December 2000 to September 2002), and a second bull period (September 2002 to December 2004). It found that the application of *Shari'ah* screens did not have an adverse impact on the performance of the indices. In the short run, a comparison of the raw and risk-adjusted performance showed that the Islamic indices performed as well as their counterparts over the entire period and in the second bull period.

In the long run, there is clear evidence that the Islamic indices performed better than their counterparts in the entire and first bull market periods. On the other hand, the Islamic indices failed to sustain their better performance over the bear and second bull periods since the counterpart indices achieved higher returns.

Hassan and Girard (2005) looked at the Dow Islamic indices for the period of 1992 to 2005 and did not find any noticeable differences in performance between Islamic and non-Islamic indices from January 1996 to December 2005. The Islamic indices outperformed their conventional counterparts from 1996 to 2000 and underperformed them from 2001 to 2005. They suggested that the period-specific performance of Islamic indices was likely to be attributable to style differences between the two types of series because they observed that Islamic indices were growth and small-cap oriented and conventional indices were more value and mid-cap focused. They also concluded that, overall, similar reward to risk and diversification benefits existed for both types of index.

Hassan and Antonios (2006) examined the performance of the Dow Jones Islamic Index against the Data Stream Global Index and confirmed earlier findings that Islamic equity investments are no less profitable than conventional investments given the relatively major differences between Sharpe and Treynor measures and significant positive Alpha over the positive returns period. The study also observed a bias of Islamic indices towards technology stocks, which proved beneficial during bull markets but affected the performance adversely during the bear periods.

Elfakhani, Hassan and Sidani (2007) performed an empirical study of a sample of 46 Islamic mutual funds to investigate the difference in behavior of Islamic and conventional mutual funds. The study concluded that the behavior of Islamic mutual funds does not differ from that of other conventional funds, with some *Shari'ah*-compliant mutual funds outperforming their benchmarks and others under-performing. The total number of over-performing funds ranged between 29 funds (63 percent of the sample) and 11 funds (24 percent), depending on the performance measure used and the market benchmark. This study made two interesting observations: there is no statistically significant risk-adjusted abnormal reward or penalty associated with investing in *Shar'iah*-compliant mutual funds; and Islamic funds can be considered by conventional fund managers, since investing in *Shari'ah*-compliant funds offers some form of diversification and hedging benefits, especially during periods of economic downturn.

## **CORPORATE SOCIAL RESPONSIBILITY**

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Advocates of Islamic finance argue that Islamic financial institutions (IFIs) will follow the principles of Islam in giving high priority to promoting social welfare and justice. If the goal of IFIs is, as they purport, to reconcile the individual pursuit of profit with the good of society as established

in *Shari'ah*, they must serve as active engines of social change rather than indifferent producers of limited and coincidental positive externalities. In this respect, IFIs should pay due attention to corporate social responsibility (CSR) and must constitute social objectives over and above the basic legal and ethical requirements mandated by *Shari'ah*.

Research on the evolution and the performance of Islamic finance has tended to highlight issues of profit and efficiency, while downplaying or ignoring the socio-political goals of the discipline and its practitioners. Sairally (2007) undertook a unique study to evaluate the corporate social performance (CSP) of IFIs in order to determine how socially responsible they are in their objectives, actions, and commitments. This study made the following observations:

- In contrast to their counterparts, IFIs have tended to engage in a strictly “defensive” approach to CSR. While they ranked screening of objectionable products, such as those that engage in *riba* and other impermissible acts, very high on their list of priorities, they ranked the selection of positive products, such as investment in companies that contribute positively to society or invest in environmentally-friendly activities, very low. An analysis of the mission and vision statements of the IFIs revealed that the majority (41 percent) embraced such a defensive approach to CSR, while only 27.8 percent engaged in a more proactive practice.
- The reported practices of IFIs displayed minimal or no commitment towards ethical employment policies and community involvement.
- Most IFIs restricted charitable activities to direct donations (of about 0–2 percent of profits) to charities and community causes. Although, this appears unexpectedly low, one possible reason could be reluctance on the part of IFIs to make such claims public, following a policy that charitable activities should be kept discreet. This is consistent with the results of the survey which showed that 87.5 percent of respondents failed to allocate a percentage of profits to the community activities in which their institutions participated.

Grais and Pellegrini (2006) observed that although there was a noticeable consistency in respecting the social obligations of Islamic finance, the emphasis by IFIs on their social role was not uniform. In a sample of 13 IFIs, the study found that all discharged their almsgiving duties (*zakat*) as required of all responsible corporate citizens by the *Shari'ah*. The majority also provided charitable loans (*qard-ul-hassan*) to help disadvantaged groups meet social obligations. The activities financed included the implementation of development and humanitarian programs, the construction of hospitals and mosques, and the financing of education, house refurbishments and in-kind donations. In general, the study found that IFIs live up to their social goals as claimed in their mission statements.

Any problems regarding a lack of transparency in providing information or with the mediocre standards of community involvement displayed by



IFIs can be alleviated through the creation of an index that tracks the social performance of companies whose activities are consistent with *Shari'ah* principles. Given that the welfare of society is the prime objective of Islamic law, it is essential that the discipline of Islamic finance establishes principles that can gauge whether IFIs are contributing significantly to this objective. Though no such index exists currently, we believe that one can readily be modeled on available ethical-investing indices.<sup>3</sup>

## PERFORMANCE IN CRISIS PERIOD

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The financial crisis of 2007–09 offered opportunities for the advocates of Islamic finance to claim that Islamic financial institutions are more resilient to the stresses of financial crises. Several studies were undertaken in support of this claim. Some studies found that the primary reason why Islamic financial institutions and capital markets were not directly affected by the sub-prime financial crisis was that they did not have any direct exposure to toxic assets and, therefore, were immune to the crisis during its early stages. However, as the crisis led to economic recession and global slowdown, Islamic financial institutions also faced deteriorating business and decline in profit margins.

Several IFIs that had exposure to real estate developments in the Middle East experienced an erosion of their asset values. Although this has yet to show up as a liquidity crisis, it is feared that a lack of strict adherence to marking assets to market may be disguising the problem, or at least delaying their being brought to the surface. Similarly, it is too early to tell if Islamic financial institutions will indeed pass through some of the losses to the depositors or if their equity capital will absorb some of the losses, as has been done in the past. In addition, several IFIs have been building reserves from previous years' profits to use during less-profitable periods. The picture should become clearer shortly. Both Islamic and conventional banks are facing problems with asset quality in the post-crisis period. For example, in depressed capital markets, the Islamic banking sector is also facing a decline of revenues derived from brokerage fees and trade finance-related fees.

Hasan and Dridi (2010) conducted a study for the IMF to assess the impact of the crisis using bank-level data covering the period 2007–10 for about 120 Islamic banks and conventional banks in eight countries (Bahrain (including offshore), Jordan, Kuwait, Malaysia, Qatar, Saudi Arabia, Turkey, and the UAE). The study used variables such as the changes in profitability, bank lending, bank assets, and external bank ratings to assess the impact. The study shows that, in profitability terms, Islamic banks fared better than conventional banks in 2008 but this trend had leveled out in 2009 as the crisis hit the real economy. In general, growth in the credit and assets of the Islamic banks continued to be higher in all countries except the UAE. The study concluded that, on average, Islamic banks showed stronger resilience during the global financial crisis. The other findings of the study were:

- Islamic banks' solvency was better, mainly due to low leverage which helped them contain the adverse impact on profitability in 2008, but their weaknesses in risk management practices caused larger declines in profitability than experienced by conventional banks in 2009.
- The weak performance in some countries was associated with sector concentration and, in some cases, was facilitated by exemptions from concentration limits.
- Islamic banks experienced higher profitability during the pre-global crisis period (2005–07), but their average profitability for 2008–09 was not much different from conventional banks, indicating better cumulative (pre- and post-crisis) profitability.
- Larger Islamic banks performed better than small ones because of better diversification, economies of scale, and stronger reputation.

In a World Bank study, Beck, Demirgüç-Kunt and Merrouche (2010) found Islamic banks to be more cost-effective than conventional banks in a broad cross-country sample but this finding was reversed in a sample of countries. Islamic banks had higher capitalization and higher liquidity reserves, which were considered the source of their better performance when compared to conventional banks. Interestingly, the study found that conventional banks that operate in countries with a higher market share of Islamic banks were more cost-effective but less stable.

Whereas analyzing the performance of financial institutions requires extensive data and information, which is not always readily available, it is relatively easy to see the performance of Islamic products in capital markets. We undertook a simple comparison of Dow Jones Islamic Indices with their conventional benchmarks and found that the Islamic indices outperformed the benchmark (whether it be US or World) when performance was measured in risk-adjusted value.

Table 11.1 shows a comparison of the Dow Jones Islamic US Index and the S&P 500 for the five-year period from December 1, 2005 to November 30, 2010. The analysis was performed on weekly index returns, and cumulative returns are reported for the last one-, two-, three-, four- and five-year periods. We computed excess return (ER), tracking error (TE) and information ratio and found that the Islamic index outperformed the S&P 500 in each year in risk-adjusted terms as measured by information ratios.

Figure 11.1 shows the weekly cumulative returns of the two indices. An interesting observation can be made here. Although, on a risk-adjusted basis, the Islamic index had better nominal returns, the S&P 500 outperformed the Islamic index from December 2005 to late 2007 when the Islamic index began to show better nominal returns. One possible explanation for this could be that the S&P 500 included financial stocks, which are not part of the Islamic index. During the boom time, the inclusion of financial stocks created a leverage effect and gave better returns; but before and during the crisis, financial stocks were hit hard.

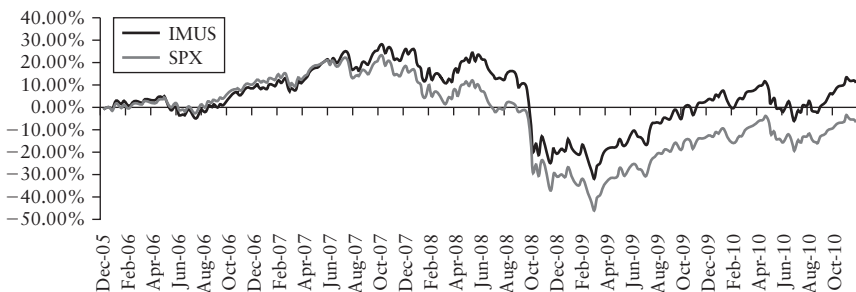
Table 11.2 and Figure 11.2 show the results of a comparison of the performance of the Dow Jones Islamic World Index and the MSCI World Index. The results are identical to those found in the above comparisons of the Dow Jones Islamic US Index and the S&P 500. In both cases, the Islamic and conventional indices had very high correlations.

A similar comparison of the S&P *Shari'ah* 500 and the S&P 500 reveals the same trends shown by the Dow Jones Islamic indices. Table 11.3 confirms that over periods of three and five years, the Islamic index performed

**TABLE 11.1** Performance comparison of Dow Jones Islamic US (IMUS) Index and S&P 500 (SPX), February 2006–February 2011

IMUS	5Y	4Y	3Y	2Y	1Y
Return	0.083%	0.060%	−0.006%	0.337%	0.196%
Sigma	2.84%	3.06%	3.38%	2.80%	2.34%
SPX	5Y	4Y	3Y	2Y	1Y
Return	0.023%	−0.023%	−0.072%	0.319%	0.194%
Sigma	3.04%	3.32%	3.69%	3.07%	2.39%
ER	5Y	4Y	3Y	2Y	1Y
Return	0.060%	0.082%	0.066%	0.018%	0.003%
TE	0.67%	0.70%	0.77%	0.69%	0.36%
IR / Sharpe Ratio	0.09	0.12	0.09	0.03	0.01
Correlations	0.976	0.979	0.980	0.976	0.989

Source: Based on data from Bloomberg



**FIGURE 11.1** Cumulative weekly returns of Dow Jones Islamic US index and S&P 500

Source: Based on data from Bloomberg

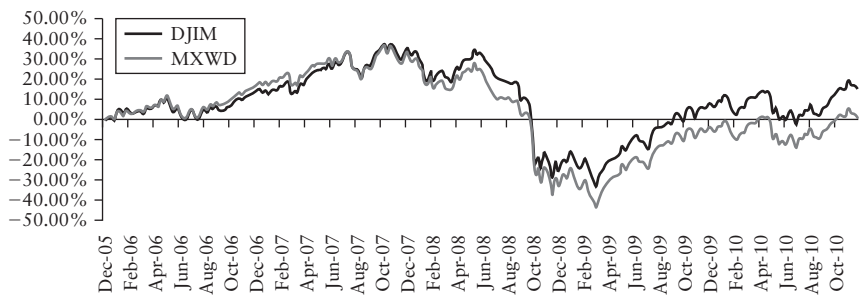
better than its counterpart and had lower volatility, which resulted in a lower Sharpe ratio. This confirms that, irrespective of the index, the performance results of Islamic and conventional indices are the same; that is, better returns, low volatility, and lower Sharpe ratios.

Table 11.4 gives a comparison of the leading ratios of the two indices. The most striking observation is the long-term debt to capital (LTD/capital)

**TABLE 11.2** Performance comparison of Dow Jones Islamic World Index (DJIM) and MSCI World Index (MXWD), February 2006—February 2011

DJIM	5Y	4Y	3Y	2Y	1Y
Return	0.101%	0.065%	−0.026%	0.410%	0.199%
Sigma	3.01%	3.24%	3.59%	2.91%	2.44%
MXWD	5Y	4Y	3Y	2Y	1Y
Return	0.06%	−0.01%	−0.10%	0.39%	0.16%
Sigma	3.16%	3.42%	3.80%	3.13%	2.53%
ER	5Y	4Y	3Y	2Y	1Y
Return	0.04%	0.07%	0.07%	0.02%	0.04%
TE	0.54%	0.56%	0.63%	0.59%	0.33%
IR / Sharpe Ratio	0.08	0.13	0.12	0.04	0.12
Correlations	0.98602	0.98698	0.98718	0.98349	0.99195

Source: Based on data from Bloomberg



**FIGURE 11.2** Performance comparison of Dow Jones Islamic World (DJIM) Index and MSCI World Index (MXWD)

Source: Based on data from Bloomberg

ratio of the S&P *Shari'ah* 500 index, which stands at 25 percent. Theoretically, this ratio, which indicates leverage, should be as close to zero as possible but Islamic indices relax the leverage requirement and select stocks of firms with low (< 33 percent) leverage.

**TABLE 11.3** Performance comparison of S&P *Shari'ah* 500 and S&P 500

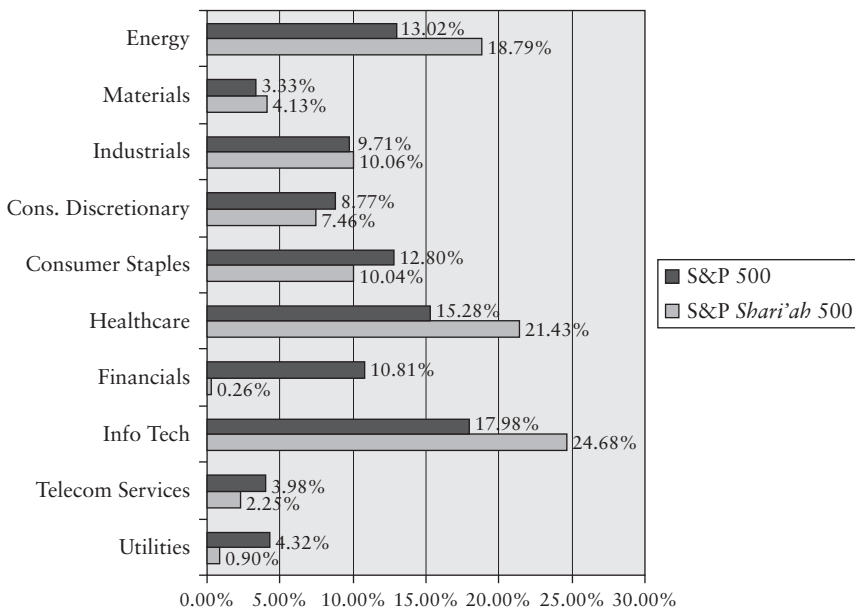
Index Performance	Quarter	YTD	12M	3 Year	5 Year
S&P Shari'ah 500	-7.23%	-7.23%	-30.22%	-7.31%	-0.67%
S&P 500	-11.01%	-11.01%	-38.09%	-13.06%	-4.76%
Standard Deviation	3 Year	5 Year			
S&P Shari'ah 500	16.35%	13.92%			
S&P 500	17.67%	14.69%			
Sharpe Ratio	3 Year	5 Year			
S&P Shari'ah 500	-0.17	-0.06			
S&P 500	-0.26	-0.13			

Source: S&P (2009)

**TABLE 11.4** Ratio comparison of S&P *Shari'ah* 500 and S&P 500

	S&P 500 <i>Shari'ah</i>	S&P 500
Market Cap (US\$ million)	80,578.20	66,828.54
P/E	12.5	11.8
P/CF	7.9	6.2
P/Sales	1.4	0.8
P/BV	2.3	1.6
3-year EPS Growth	17.1	12.9
3-year Sales Growth	12.8	12.6
ROE	25.8	21
ROA	12.8	9.6
LTD/Capital	24.9	32.9
Operating Margin	21.2	18.6
Net Margin	13.6	11
Dividend Yield	2.54	3.42

Source: S&P (2009)



**FIGURE 11.3** Comparison of sector allocation of S&P 500 and S&P Shari'ah 500  
Source: S&P (2009)

Figure 11.3 shows the sector allocation of two indices and reveals that the Islamic index has almost no allocation to the financial sector, which confirms our earlier assessment that Islamic indices have done better in the crisis period when investors suffered losses due to problems in the financial sector whereas Islamic investors had no exposure to that sector.

An S&P study found that, in the first nine months of 2008, commercial Islamic banks continued to exhibit strong profitability, reporting an average return on assets (ROA) of 3.1 percent. These banks appear to have benefited from the supportive economic environment that prevailed in the first half of 2008, from their good efficiency and from the low cost of risk. In line with the Islamic principle that all transactions must be backed by a real asset, one of the preferred asset classes of Islamic banks is real estate. Studies show that the total direct exposure to the real estate sector for IFIs is equivalent to about 20 percent of total lending, which is high and increases the IFIs' exposure.<sup>4</sup> With deteriorating market values, IFIs can face problems in passing the losses to investors/depositors unprepared to face this reality. IFIs will have to wait and hope for a rebound in these values to achieve modest returns for their investors/depositors.

In 2009, the Islamic International Rating Agency (IIRA) conducted a survey of key Islamic banks to assess their liquidity position and concluded that although they were not entirely immune from the impact of declining real estate values and restricted real estate lending, these banks were less

likely than conventional institutions to suffer negative outcomes beyond their capacity to sustain core profitability and capital.<sup>5</sup> The report showed that, on average, during 2008 the impact of the global crisis on liquid assets remained limited, as reflected in a modest downward adjustment of the liquidity ratio. Liquid assets as a percentage of total liabilities declined during 2008, which indicates the banks' use of internal resources to manage the funding shortfall. From being net providers of funds in 2007, many Islamic banks became net borrowers from the interbank market during 2008—an indication of their increased liquidity needs. A few banks have large maturing liabilities, which has resulted in a significant negative gap; while some have sufficient maturing assets to support their maturing liabilities.

The performance of Islamic financial institutions can be considered good, especially in light of the fact that Islamic institutions are part of an emerging and developing market that is trying to overcome many challenges and obstacles. The returns to Islamic banks have been comparable to those of conventional banks. No Islamic bank has failed as a result of the sub-prime crisis. The risk-adjusted returns of some Islamic capital-market products are higher than comparable ones in conventional markets. These are, however, preliminary results and may change with time.

## **BANK FAILURES**

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Although there has not been a major failure in more than 30 years of the Islamic banking industry's history, there have been instances of failures of financial institutions claiming to offer Islamic financial products. A review of the causes leading to their failure can shed light on how it could have been avoided, how other institutions offering similar products and services were affected and how they can learn from these experiences.

### **Ihlas Finans<sup>6</sup>**

Ihlas Finans was a Turkish institution that behaved similarly to a deposit-taking bank offering *Shariah*-compliant financial services. These financial houses were not recognized as part of the regular banking sector but were given the status of Special Finance Houses (SFHs), as they were considered to be offering non-conventional and specialized services. SFHs constituted only 3.1 percent of the total banking-sector deposits, and their investment allocations represented only 4.7 percent of the total. As SFHs, these institutions were not subject to the same regulations as other institutions in the banking sector. For example, SFHs were considered an uninsured sub-sector of Islamic banks.

In early 2000, the Turkish financial sector went through a macroeconomic and financial crisis which affected the entire banking sector and led to the failure of some conventional banks. Of the five SFHs engaged in Islamic finance, however, Ihlas Finans was the only one that did not survive.

Ihlas Finans was a subsidiary of Ihlas Holdings, a social-oriented business organization established in the 1970s that eventually grew into a large holding company. While its core business was in the fields of construction, healthcare, and education, it had a number of subsidiary businesses ranging from manufacturing of household appliances, to news media, to providing financial services and insurance of various kinds. Ihlas Finans was one such subsidiary, established in 1995 with the objective of providing interest-free investment opportunities to investors and small savers. Registered as a Special Finance House with the Central Bank of Turkey, it grew into the largest of its class. The balance-sheet assets had grown from US\$17 million in 1995 to US\$1,173 million by 1999,<sup>7</sup> with a majority market share of 40 percent.

However, in the wake of the banking crisis that developed in Turkey in the last quarter of 2000 and early 2001, the company faced a run on its deposits. On February 10, 2001, the Banking Regulation and Supervision Agency (BRSA) intervened and cancelled its license, leaving the company's 200,000 depositors around the country unsure as to what had become of their deposits. The BRSA cited several reasons for this action. First, it announced that Ihlas Finans had irregularly appropriated almost US\$1 billion (practically the entire value of deposits) through connected lending to shareholders.<sup>8</sup> Second, it considered that the company was unable to fulfill its obligations to the public and therefore to be in violation of banking rules. Third, there were irregularities, as Ihlas had made substantial investments in its subsidiaries and with the agents of its subsidiaries.

The detailed analysis of the case conducted by Ali (2007), highlights several factors for the failure of the institution and holds several stakeholders and deteriorating market conditions responsible for this failure. While there was clear evidence of carelessness on the part of the regulators and supervisors, who were unable to detect the warning signs in time, here we focus primarily on those factors where the management of Ihlas Finans was directly responsible for the negligence and where the *trust* of the stakeholders was breached through misrepresentation. It is important to understand the implications of these factors since they were the source of considerable concern for the depositors of other SFHs and to the reputation of the industry in the country. These factors are summarized below.<sup>9</sup>

**Weak Governance Structure** It appears that Ihlas Finans was not following the best practices in corporate governance. For example, it is reported that the members of the Board of Directors showed a lax attitude towards governance and some members appointed to the board did not have the requisite experience. Since Ihlas Finans was a subsidiary of a large holding company, some of its board members represented multiple boards, which resulted in a conflict of interests.

**Fraudulent Practices** It appears that Ihlas Finans tried to conceal its financial and managerial failures by indulging in fraudulent practices. For example,



it was discovered that some of the agency (*mudharabah*) financing was done in the name of fictitious parties, while the funds were in fact used for concealing internal financial problems.

**Lack of a Risk-management Culture** There were serious flaws in the company's risk management framework. Credit was extended to finance other businesses in sibling holding companies and some of the clients became heavily dependent on Ihlas as a source of funding, thus increasing exposure to credit risk. The depositors' funds were used to finance several businesses of Ihlas Holdings which in turn placed the funds in highly illiquid projects such as construction. Even though these projects were profitable ventures, they led to increased liquidity risk for Ihlas Finans and were cited as one of the primary reasons for its failure. It is evident that Ihlas Finans lacked a crisis-management plan, and decision-making during the crisis was ad hoc and uncoordinated, internally and externally.

**Management Failure** It appears that Ihlas Finans did not follow the best practices in management and did not act in good faith. Its hiring and selection process was called into question when it was shown to have hired a senior executive who was the subject of a BRSA investigation of a failed bank—adding further fuel to customers' concerns and damaged their confidence. Furthermore, the management was slow in responding to the changing legal and regulatory environment and demonstrated poor judgment by ignoring the severity of the problem during the early phases of the crisis. For example, while other SFHs were able to convince depositors to hold off on their withdrawal requests to avoid a liquidity crunch, Ihlas Finans lost more than US\$200 million-worth of its most liquid assets by paying out on depositors' demands even before the liquidity crunch hit. As a result, withdrawal requests increased, which ultimately placed pressure on the BSRA to close down the institution.

### **The Islamic Bank of South Africa**

The Islamic Bank of South Africa (IBSA) failed in November 1997 with debts of between R50 million and R70 million. The primary depositor base of the IBSA consisted of small depositors, mostly Muslims, who saw it as a community bank and deposited their money to make the Hajj pilgrimage to Mecca. Okeahalam (1998) conducted an analysis of its failure and the role of the supervisors, and concluded that bad management and improper accounting and management systems caused the bank to fail. Allegedly, a large amount of insider unsecured lending took place, which resulted in a large proportion of non-performing assets in the balance sheet. The study found that the bank's management hid behind the self-regulatory position accorded to true Islamic banks but that IBSA abused this special trust. The regulators should have been more cautious.<sup>10</sup>

Further details of the causes of failure are found in van Greuning (2005), who makes the following observations:

- IBSA claimed to share profits and losses with ratios of 66 percent for the investor and 33 percent for the bank. However, in fact, the bank paid 11–13 percent return regardless of actual profits or losses, which created a false image of the health of the institution to potential investors. The bank was to provide a monthly P&L statement, something that was never done. Profits and losses were distributed at the discretion of the CEO, with no records to back them up.
- It was discovered that numerous loans were made to the directors. There was evidence of connected lending, self-dealing and insider lending through an over-extension of credit to directors and large shareholders, or to their interests. Forty percent of non-performing loans had never paid anything since they were set up. Twenty-seven percent of loans were to insiders.
- Shareholders did not pay in their capital (capital was immediately lent back to the shareholders), so the “cash” received was converted into a loan. Accordingly, there was a negative impact for depositors since they had no “buffer” against their losses. One shareholder had more than 15 percent control and hid his stake through front companies.
- There were no risk committees to assist the board; thus, management and decision-making were performed within an extremely informal framework. Banking law was also breached because audit committees and internal audits did not exist. Banking law also required directors to be “fit and proper” and understand the “business of banking and banking risks”; however, the liquidator did not find this to be true as there were no risk-management systems in place. Furthermore, credit information was incomplete, since the purpose of borrowing and the intended plan and source of repayment were not specified.

The IBSA case clearly shows that the bank was not following basic banking practices. The management was guilty of misrepresentation and indulging in unethical practices, which resulted in the distortion of information and a lack of transparency. The regulators had assumed that the bank would impose the discipline of self-regulation and did not supervise this prudently. Consequently, this trust was breached when detailed investigation revealed the wrongdoing of the institution.

### **Islamic Investment Companies in Egypt<sup>11</sup>**

In Egypt in the 1980s, the activities of certain investment companies came to the attention of regulators and the media in Egypt in the years 1985 to 1988. These companies were based on a profit-sharing principle (*sharikat tawzif al-amwal*), accepting deposits from the public and investing funds in *Shariah*-compatible modes. During 1985 and 1986 they attracted the attention of investors by offering high rates of return (20–30 percent), claimed as profits. By the end of 1986, there were 190 registered companies engaged with private investment and operations, and 90 non-registered companies. According

to some estimates, by 1988 they had managed to attract about half a million customers and had deposits of between 4.5 and 8 billion Egyptian pounds.

The rate of return offered was so attractive that money flew out of the regular banking sectors, and, in some cases, investors created arbitrage by borrowing from banks and investing in these companies. However, these companies were not subject to any regulation and supervision, and their operations lacked transparency. These investment companies and their activities were exposed, however, in 1988 when the government decided to regulate the sector by requiring full disclosure of their accounts and investment activities. This regulation triggered the failure of several companies and the closure of the majority. Below is a summary of the issues pertaining to this case study.

- It appears that the investment companies were not following *Shari'ah*-approved modes of investment, despite their claims. In some cases, they were paying high returns by drawing on a continuing high level of deposits, as opposed to actual profits.
- It was reported that investments of a speculative nature were made in international currencies and financial markets. When the prices collapsed in international markets in 1987, many investment companies suffered losses. A major portion of funds were invested in illiquid sectors of construction, tourism, housing, and book publication (mostly Islamic publications). Several investment companies maintained close business partnerships with other trading companies and managed a number of subsidiaries. In short, funds were used to finance the businesses of subsidiaries and partner trading companies.
- Official audit reports discovered many irregularities and funds unaccounted for, partly in complex transactions with subsidiaries. Authorities began the investigation of select investment companies for criminal charges.

Several lessons can be learnt from these three case studies. First, the main cause of the failure in all three cases was irresponsible management and bad supervision and governance. Second, there were lapses in both regulation and supervision. There were improper regulatory frameworks, and in all cases the regulator failed to anticipate the trouble in time. Third, these financial institutions were clearly engaged in activities that were against the basic teachings of Islam on contracts, property rights, justice, trust, and honoring commitments. Fourth, in all cases, none of the Islamic financial instruments were questioned or gave rise to concern. Finally, in all three cases, significant reputational risk resulted and the stakeholders' confidence was seriously damaged. The public's trust was broken, regulators became more suspicious and cautious, and opponents were provided with fuel to criticize even a legitimate effort to establish a financial institution compliant with *Shari'ah*.

It should be reiterated, though, that these failures arose from a combination of gross mismanagement, poor governance, negligence, misconduct, and

misrepresentation,<sup>12</sup> and were in no way attributable to the special nature of Islamic financial institutions per se. Indeed, during the past three decades—including the current financial crisis—no major Islamic bank has failed where the failure can be attributed to their special form of intermediation.

## ENDNOTES

1. [http://www.erf.org.eg/cms.php?id=publication\\_details&publication\\_id=648](http://www.erf.org.eg/cms.php?id=publication_details&publication_id=648)
2. Čihák and Hesse (2008).
3. Sairally (2007).  
For example, within the SRI literature, we note that Business in the Community (BITC)—a movement with a core membership of 650 companies across the UK—established a corporate responsibility index in 2002. This BITC Index functions in a similar way to other ethical and social indices, such as the FTSE-4Good, the Dow Jones Sustainability Index, and the Domini 400 Social Index, in that it publicly ranks major international companies according to their SEE performance.
4. Ibid.
5. IIRA (2009). The sample of key Islamic commercial banks included Al Baraka Islamic Bank Bahrain (Albaraka), Al Salam Islamic Bank Bahrain (Al Salam), Bahrain Islamic Bank (BIsB), Dubai Islamic Bank (DIB), Jordan Islamic Bank (JIB), Khaleeji Commercial Bank (KCB), Kuwait Finance House Bahrain (KFH) and Meezan Bank Pakistan Limited (MB).
6. For a very detailed analysis, see Ali (2007).
7. Ibid.
8. Shares of Ihlas Group were suspended from trading, driving the stock market down 4.9 percent in one day; see Starr and Yilmaz (2006).
9. Ali (2007).
10. Okeahalam (1998).
11. Zuhaida (1990); Hasan and Dridi (2010); Beck, Demirgüç-Kunt and Merrouche (2010).
12. See Askari, Iqbal, and Mirakhor (2008) for case studies on the failure of financial institutions offering Islamic products.

## CHAPTER 12

# Financial Engineering

**F**inancial engineering and innovations are the forces driving the global financial system toward the goal of greater economic efficiency. The 1980s witnessed the rapid introduction of financial innovations in the international markets. Financial innovations transformed the traditional financial and banking markets into highly sophisticated markets featuring a high degree of liquidity and a wide array of instruments to share and transfer various sources of risk. The trend occurred in both domestic and international financial markets. The demand for liquidity-enhancing and risk management instruments was prompted by the increased volatility in financial asset prices arising from the breakdown of the fixed exchange-rate system, the oil shocks, excessive government spending and inflationary policies. The innovation and growth in financial markets was further induced by advances in theory, breakthroughs in the information-processing and communication technology and deregulation of markets.

Financial engineering involves the design and development of innovative instruments and processes, as well as the search for creative solutions to problems in finance. Financial engineering may lead to a new consumer-customized financial instrument, or a new security, or a new process which ultimately results in the lowering of funding costs or in increasing return on investments or expanding opportunities for risk sharing. The types of financial-innovation activities that have the most significant impact on the markets are those that:

- Enhance liquidity. Marketability, negotiability, and transferability of financial claims create liquidity by expanding the menu of options available to market participants.
- Transfer and share price and credit risk through the development of derivatives markets. Derivatives, apart from risk sharing, make markets more complete and create important additional social benefits such as the dissemination of uniform prices upon which investment decisions can be made, and the lowering of transaction cost in the capital markets.
- Generate revenues from credit and equity.

Financial development and innovations have had a positive impact on the economic growth of various countries. One of the advantages of financial engineering is that it is for the common good and that there is no copyright on financial products. Once an instrument is launched, it can be copied by anyone, improved upon, combined with other instruments and re-launched.

In addition to broadening choice, financial engineering facilitates the transformation and reshaping of risk. It thus supports the development of new products that break down, transfer and pool risks to match the needs of users. The development of new financial instruments has created opportunities for households and companies to improve their management of financial, liquidity, market, and credit risks, which has facilitated the smoothing of inter-temporal consumption and investment across space.

Financial engineering has also been used often to exploit and to overcome investment regulations applied to US institutional investors. The investment regulations may restrict exposure to certain asset classes, or to an investment-grade credit rating, or preclude exposure to foreign exchange risks or foreign credit risk. For example, a fixed-income manager's investment guidelines may prevent investment in equities but a desirable exposure to equities may be achieved through a structured note where a fixed-income security has embedded exposure to returns in equity markets; thus achieving a play in equities markets and still complying with regulatory requirements.

## **FINANCIAL ENGINEERING IN THE ISLAMIC FINANCIAL SYSTEM**

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Financial engineering is one of the most critical current needs of Islamic financial markets in general and of Islamic risk management practices in particular. IFIs are still operating on traditional instruments, which do not fully satisfy market needs for liquidity or for risk and portfolio management. The asset portfolios of IFIs predominantly consist of trade-related short-term assets. There is a shortage of products for medium/long-term maturities, as secondary markets lack depth and breadth.

The lack of efficient secondary markets and liquidity in the Islamic financial markets has indirectly limited the range of maturity structures available to the investor. Given the absence of liquidity, IFIs cannot easily expand portfolios across capital markets and are restricted in opportunities for portfolio diversification. This presents a challenging opportunity of developing highly liquid instruments to satisfy the demands of the investors and the users of funds seeking longer maturity structures with the flexibility of adjusting portfolios at the lowest cost.

The absence of risk management tools will continue to have a significant impact on the current and future growth of the market because:

- A firm in the Islamic financial markets will lose its business competitiveness because of its inability to handle variability in its cost, revenues and profitability through managing financial risk
- A firm without active risk management will be perceived as a high-risk firm and thus will be subject to higher funding costs
- A firm will be subject to high risk of financial distress
- A firm will be exposed to a higher risk during a system-wide financial crisis
- It will be difficult for IFIs to integrate with the international financial markets.

The key to the rapid development of secondary markets and of liquidity-enhancing products for implementing effective risk management is the application of financial engineering.

The pace of financial engineering in Islamic finance has been very slow by comparison with the conventional system. There are several reasons for this slow growth.

As an emerging market, the focus has been on establishing intermediation services and attempting to get recognition in international financial markets. Therefore, there has been more emphasis on ironing out the basic functionality of the banking and financial systems and the corresponding regulatory and standard-setting framework.

Second, introducing a new, *Shari'ah*-compliant, product requires considerable effort as it has to receive approval from *Shari'ah* scholars, not all of whom are necessarily well-versed in economics and quantitative finance. As we will see in the next section, the *Shari'ah* has not established a clear stand on the permissibility of derivatives, which have played a key role in advancing financial innovation.

In addition, all attempts at financial engineering have revolved around replicating a conventional security that is easily recognizable by investors and borrowers. However, it is sometimes easier to develop new products than trying to replicate a conventional security, which may lead to more confusion and questions about the product.

Finally, although academic research on Islamic economics and finance has made healthy progress, it has not developed fully to the point where it is able to tackle certain critical issues such as asset pricing, risk premium, risk mitigation, hedging, and so on.

All these factors have combined to slow down the introduction of new products in the Islamic financial market.

### **Scope of Financial Engineering**

The process of financial engineering can be viewed as a process of building complex instruments utilizing basic building blocks or unbundling and repackaging different components of existing financial instruments such as return, price risk, credit risk, country risk, and so on. Today's highly liquid instruments and derivatives are based on a simple and basic set of instruments.

A close scrutiny of the instruments underlying the Islamic financial system reveals that these instruments have characteristics similar to many of today's basic building blocks and it is a matter of designing more complex instruments without violating any of the boundaries defined by the Islamic system.

The process of financial innovation is complex and sensitive, as it requires multi-disciplinary considerations involving not only knowledge of economics, finance and banking, but also a deep understanding of Islamic jurisprudence. Throughout history, pious Muslim businesses and traders have worked closely with *Shari'ah* experts, and centuries of experience across several geographical regions have grown into a rich body of *Shari'ah* rulings and precedents in the area of business and economics. However, the process of innovative application of the *Shari'ah* through *ijtihad* to resolve the problems of the time has been dormant for a long time and there is a need to revive a practice that was once alive and vibrant.

The process of determining the legitimacy of a new product involves approval by *Shari'ah* scholars who ensure that the new product does not violate any of principles of the *Shari'ah*. From a legal point of view, any instrument is acceptable as a legitimate financial instrument provided it does not incorporate certain elements considered unlawful in Islam.

Suwailum (2006) suggests four guiding principles for financial engineering: two concern the objectives—balance and integration; and two concern methodology—acceptability and consistency. Here, we extend his ideas to bring some additional principles which would influence the process and practices of financial engineering.

**Adherence to the Essence and Spirit of *Shari'ah*** The *Shari'ah* is not just a set of laws; such laws have well-meaning objectives, commonly referred to as the objectives of the *Shari'ah* (*maqasid-al-Shari'ah*). These are designed to implement the essence or the ideology of Islam, which primarily revolves around promoting unity, social justice, social welfare, the preservation of property rights, and economic development. Therefore, any attempt to develop a product or process that runs counter to these core objectives will not be acceptable. However, by keeping these objectives in sight, financial engineering will lead to an increase in overall social welfare.

The objectives of the *Shari'ah* provide the first line of defense against the introduction of any innovation that is deemed to have the potential for being counterproductive under any market conditions. For example, financial engineering cannot result in any product that leaves either lender or borrower open to exploitation by the other under some market conditions. Before approval can be given for any innovation, there would have to be an impact assessment at the macro level. Although this would not be an easy task as it involves subjective and qualitative judgment, the consistent application of the core principles would serve that purpose.

**Freedom of Contract** An understanding of the laws governing contracts in Islam is critical. Individuals have wide freedom of contract and the



contracting parties are free to engage in any transactions not prohibited by the *Shari'ah*. In other words, any transaction is permissible so long as it does not contain any of the prohibited elements of *riba*, *gharar*, *qimar* and *ikrah*. Historically, *Shari'ah* scholars would not dictate how a contract should be formulated, but it was a common practice by economic agents to bring a contract to the *Shari'ah* scholar who could only declare its legitimacy or non-compliance by testing for the prohibited elements. If the *Shari'ah* scholar did not find any of the prohibited elements, the contract was given the blessing of compliance. This practice implies that rather than imposing restrictions on the contracts, *Shari'ah* gives freedom of contract to the parties so that they can develop new tools and mechanisms of financing and lending, and the role of the *Shari'ah* scholar is limited to ensuring that the contract is valid. Financial instruments and services should be viewed as sets of contracts, which identify the rights and obligations of each party. The *Shari'ah* scholar can examine the contract to verify that these rights and obligations are preserved according to the notions of contracts and property rights in Islam.

This simple principle has significant implications. It means that the basic contracts can be used to build more complex building blocks, opening up the possibility of spanning products to meet customized risk/return profiles. This contradicts the common impression that *Shari'ah* rules hinder creativity and the expansion of financial products and services. Islam encourages entrepreneurship, which signifies risk taking, innovation and creativity that will encourage financial products, processes and services which promote risk sharing and equity participation.

**Availability of Basic Building Blocks** Almost all of the complex financial instruments in today's conventional financial markets can be broken down to a set of basic instruments. For example, a floating-rate bond with a cap and floor on its coupon is nothing but a plain-vanilla floating bond with a call and a put option. Even call and put options can be replicated using cash and fixed-income instruments. No effort to introduce financial engineering into the Islamic financial system can take place without an understanding of the basic building blocks of that system and the principles that can be applied to build more-sophisticated instruments.

**Customizing Risk/Return Profile** It is also critical to develop an understanding of the spectrum of the risk/return profiles of different financial instruments. Often the Islamic financial system is equated with an all equity-based system, which ignores the fact that the system also has several other types of contracts which are not based on profit/loss-sharing. Like sales, trade financing and leasing contracts constitute a large portion of the system, but these are not based on equity and have a risk/return profile that is very similar to a conventional fixed-income security—a vital part of the more exotic financial instruments. While the instruments based on *murabahah*, *salam*, or *ijarah* contracts may resemble an interest-bearing, fixed-income

instrument, these are allowed and recognized by the *Shari'ah* and carry different risk/return characteristics. As discussed earlier, the introduction of securitized assets will exploit these instruments to design and customize risk/return profiles that are critical for the efficient construction and management of portfolios.

**Promotion of Risk Sharing and Reduction of Leverage** The prohibition of interest in Islam curtails the creation of leverage through debt. Instead, the system promotes a balanced sharing of risks and rewards through equity- and partnership-based financial contracts. Following these principles, the financial engineer will focus on developing products which promote risk sharing through making full use of equity (*musharakah*) and partnership (*mudharabah*) contracts. Not having access to debt, the financial engineer will find it difficult, if not impossible, to create leverage.

**Materiality and Linkages** The founding principle of Islamic economics is to promote the real sector—that is, goods and services—and to link the financial sector to it as closely as possible. *Shari'ah*, therefore, insists on the integration of the two sectors to achieve balanced and sustained economic growth. If they are not coupled well, transaction costs increase and efficiency suffers. Financial engineering in Islam will focus on innovations which promote real-sector activities and offer innovative ways to finance these activities. By using risk-sharing contracts, the financial engineer will rely on asset-linked securities through the securitization of real-sector assets. *Shari'ah* rules concerning ownership also ensure that there is clarity in asset ownership by the investor and thus the issue of “remoteness” of assets and ownership witnessed in the conventional system will be minimized.

**Transparency and Simplicity** Financial engineering in the Islamic financial system seeks to eliminate *gharar* through advocating the reduction of asymmetrical information between the parties. Products would be designed to avoid having excessive uncertainty regarding the future payoffs and risks for either party. Where there are unknowns, these would be fully disclosed at the time of the contract. A judicious application of this principle will make the products transparent and will reduce their complexity.

### **Different Approaches to Financial Engineering**

The principle of financial engineering to introduce advanced financial instruments can be applied in the following ways:

**Reverse Engineering or “Wrapping”** The first approach entails taking an existing instrument in the conventional system and evaluating each of its components to find the closest substitute from the basic set of *Shari'ah*-approved instruments. This means breaking down the instrument and then rebuilding

it, using equivalent instruments from the set of *Shari'ah*-approved instruments. This approach is very similar to a common practice where conventional instruments are disguised under *Shari'ah*-friendly names such that *Shari'ah* "wrapping" takes place around the conventional instruments to produce an Islamic instrument.

The major advantage of this approach is the instant recognition and understanding it gets from the practitioners of conventional finance; this paves the way for efficiency and the integration of Islamic financial markets into the conventional system. This approach may be used for determining the legitimacy of a product when it is introduced into a conventional market. This will make it easy for the regulatory authorities of the host country to understand the instrument, which will facilitate its speedy approval. Extreme care is required in this approach in order to avoid any misidentification of close substitutes. Any misidentification or use of a wrong substitute can not only break the trust of investors, but will also create a reputation risk for the industry. All efforts should be made to avoid any contamination from instruments that are close substitutes but not fully *Shari'ah*-compatible. Contamination may occur when an Islamic instrument or contract is used where its intended usage is either doubtful or questionable, or some important features or conditions of the contract are compromised. This danger of contamination will increase as the level of complexity of the instrument increases.

**Innovative Engineering** A second approach to financial engineering, preferable in principle to "reverse engineering," is to design instruments *de novo* from an established menu of Islamic instruments. The result will be a new array of instruments, each with a unique risk/return profile, that can be bought and sold in specialized markets compatible with *Shari'ah* principles. Since this approach requires a deep understanding of the Islamic economic and financial system as well as the risk/return characteristics of each basic building block, it is a long-term solution and requires extensive research and commitment. Although this approach is better aligned with the essence of the *Shari'ah*, pioneering new frontiers in a different paradigm always poses new challenges and takes time. Some of the prerequisites of or for an Islamic financial system, such as efficient markets, information symmetry and *Shari'ah*-compatible property rights and regulatory and supervisory laws, are absent from most of the developing Islamic countries.

Although this second route is, in principle, the better approach, operational difficulties associated with it impose constraints and force compromises. It is conceivable that given the pressing need for innovation, the first approach will dominate in the short term, and that some combination of the two approaches will be adopted in the medium term. However, the full potential of the system will only be achieved if serious efforts are made to introduce new instruments that provide unique risk/return characteristics that are equally desirable for Islamic and non-Islamic financial markets.

## STRUCTURING TAMWEEL SUKUK

The Tamweel *sukuk*—a \$210-million secured floating-rate note issued by Tamweel Residential ABS Ltd in July 2007—is said to be the first international real-estate mortgage-backed security (RMBS) from the six countries of the Gulf Cooperative Council (see Figure 12.1).

Tamweel's objective was to move part of its residential financing portfolio which consisted of *Shari'ah*-compliant mortgages based on the *ijarah* structure off its balance sheet so that the funds could be used elsewhere. According to the *ijarah* arrangements, customers would lease a villa or apartment from Tamweel and make periodic rental payments. At the end of the lease, if all of the rental payments had been made, the lessee (owner) would obtain the title to the property.

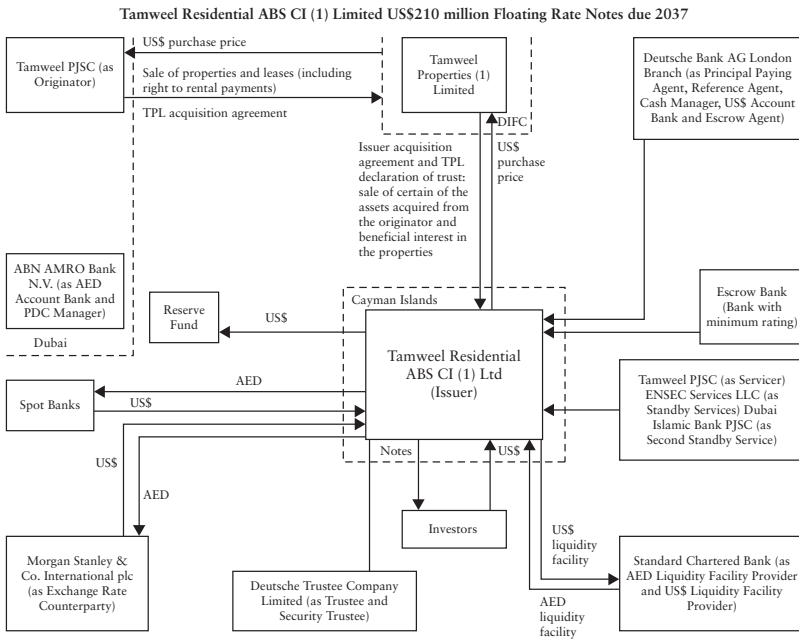
The Tamweel Class A *sukuk* were structured in such a way that they would pay a variable return rate to investors of one month US\$ Libor +35bps. The *sukuk* received an Aa2 rating from Moody's Investors Service and AA from Fitch Ratings Limited, which are among the highest international ratings achieved thus far in the Middle East and North Africa region.

### Objective

As a *Shari'ah*-compliant home finance provider, Tamweel required a range of innovations and adjustments to conventional securitization structures that would allow them to accommodate residential leases rather than mortgage loans as the securitized assets. This meant that the securitization vehicle took on continuing obligations as lessor under the residential leases, which required further tailoring procedures.

From a *Shari'ah* compliance perspective, the challenges of structuring were that the investors could only have recourse to the underlying assets; there had to be a liquidity facility; and, as the revenue stream was in UAE dirhams and the issue was to be in US dollars, there had to be some form of hedge against currency-exchange risk.

## Structure



**FIGURE 12.1** The Tamweel *sukuk*

## Key Features of *Sukuk*

### *Recourse to assets*

Under *sukuk* the investors become the owners of the pool of financial assets and the revenues and returns generated by those assets is their sole payment source. Most *sukuk* issued in the market have involved investors acquiring assets but not having full ownership of the underlying asset or based on a promise by the issuer to buy the underlying asset at a predetermined price. In other words, the main focus of the investors has been the creditworthiness of the issuer, rather than the value of the underlying assets. Because of this disconnect, *sukuk* have often been labeled as asset-backed, rather than asset-linked. A statement issued by the AAOIFI has raised concerns about the use of such structures.

The Tamweel issue, however, did not have any type of predetermined purchase undertaking and also ensured that the title to the assets has

(Continued)

## STRUCTURING TAMWEEL *SUKUK* (CONTINUED)

passed to the investors, with no recourse back to the originator (other than in limited circumstances, such as misrepresentation).

In this respect, the Tamweel structure was considered more compliant with the requirements of both the customer and the rating agencies, and also fell within *Shari'ah* parameters.

### ***Multi tranches***

Structuring multiple tranches of securitization to cater to investors of different levels of creditworthiness is common practice in conventional securitization. However, replicating the same in a *sukuk* structure is a real challenge because of *Shari'ah* requirements that all investors are treated equally. In the case of Tamweel, *Shari'ah* scholars were convinced that such tranching was possible without violating *Shari'ah* principles. This was done by arguing that it was possible for the investors to agree to subordinate their interests so that different classes of investors obtained differing returns and at different times.

### ***Liquidity facility***

Another interesting feature of the Tamweel *sukuk* was the introduction of a liquidity facility to cover any delay in the collection of rentals from the underlying leasing agreements such that the flow to investors was not disturbed. This was achieved by applying a *qard-ul-hassan* mode of financing.

### ***Currency-exchange mechanism***

The cashflows from the rental payments were denominated in UAE dirhams (AED), whereas the *sukuk* was denominated in US dollars, which give rise to classic exchange-rate mismatch risk. This risk was mitigated by ensuring that in the event of the current fixed/pegged rate between the two currencies being broken, a financial institution would agree to exchange dirhams in the future for US dollars at the pegged rate. This hedging facility was provided by Morgan Stanley & Co. International plc and steps were taken to ensure that the facility met all the *Shari'ah* requirements.

Source: de Belder (2009). The authors are grateful to SNR Denton, formerly Denton Wilde Sapte, for sharing the case study. See: [http://www.snr-denton.com/pdf/Syndicated\\_and\\_Structured\\_IF\\_Chapter\\_3.pdf](http://www.snr-denton.com/pdf/Syndicated_and_Structured_IF_Chapter_3.pdf)

## **LESSONS FROM THE FINANCIAL CRISIS**

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The financial crisis that started in 2007 has highlighted several shortcomings concerning the role of financial engineering and financial innovation. These vulnerabilities were not evident during the boom and high growth period but became a significant factor as the crisis developed. There are a number of frictions and market imperfections that lower the effectiveness of financial innovation. These have become much more apparent during the current crisis as primary market issuance and secondary market trading of some innovative financial instruments fell sharply and led to a serious liquidity crisis.<sup>1</sup>

While financial innovations have made a significant contribution to economic development, it is worthwhile examining their negative aspects—their complexity, remoteness, liquidity issues, and lack of transparency—and the impact they have had on the financial crisis.

Some of undesirable and unwanted aspects of financial engineering include increased complexity, remoteness, liquidity issues, and lack of transparency, which are discussed further below.

### **Complexity**

Increased globalization and financial integration has given rise to highly interconnected markets which respond quickly—and sometimes unexpectedly—to external events. Financial products developed with payoffs linked to different asset classes and with exposure to multiple markets have led to complicated products requiring a delicate balance. With high customization to meet specific market views, financial innovation has created a new breed of exposure: exposure to complexity. Increased complexity has made it difficult for market players, on both demand and supply sides, to fully comprehend all payoffs and exposures in all possible states of the world and has led to greater complexity across the financial system. This complexity has made the task of regulators and supervisors that much more difficult.

### **Incomplete Information and Customization**

The vision of a world of complete and efficient markets for risk depends on having full information. This full-information requirement sounds deceptively simple but is actually extremely onerous. An investor needs to know the mapping between states of the world and the payoffs they would receive in each state as well as the likelihood of these states of the world materializing. It entails not only understanding the details of highly complex contracts but also the effects of the interplay between exposures and contracts of all the other agents in the economy. Not surprisingly, many of the problems that have occurred over the crisis have arisen out of incomplete and asymmetric information.

Because many financial products are so highly customized, it is often not easy to fully grasp their inherent risks. An over-reliance on quantitative

analysis in a make-believe world can lead the unwary into uncharted waters or give a false sense of security. Taleb (2007) highlighted the flaws in the general assumptions and statistical properties of payoffs very frequently used as a foundation of financial innovation or risk measures. With highly customized payoffs, incomplete information can indeed have an impact on the stability of financial systems.

### **Liquidity**

There is also an important and fundamental tension between the capability of financial engineering to tailor financial products to meet individual investor demand more effectively, and secondary market liquidity. The more closely a specific financial instrument is matched to the risk preferences of an individual investor, the harder it is to find another investor willing to trade that exact instrument in the event of a shock to those risk preferences.<sup>2</sup>

Early on in the current crisis, risk screening and the availability and quality of information on the performance of complex products were recognized as being significantly weaker than previously anticipated. This became obvious when, for example, investors lost confidence in the quality of credit ratings, which led to a substantial increase in the risk premium required to hold such assets. These effects made the valuation of assets extremely uncertain and contributed to the rapid evaporation of secondary market liquidity.<sup>3</sup>

While a financial product may not ring alarms during the normal course of events, it can suddenly be exposed to liquidity risk even with minor signs of a crisis. This can immediately lead to deteriorating asset value due to high liquidity premium and can offset the benefits of the financial instruments for portfolio or risk management.

### **Remoteness**

Securitization is often cited as one of the factors in the development of the financial crisis. A closer look, however, shows that the process of securitization itself was not to blame, but that the problem was the loss of information that was built into the process because of the separation between the originator of the loan and the end investor. In other words, the securitization process was carried with multiple layers of intermediaries and with multiple levels of competing and often conflicting interests, resulting in a gulf between the investor and the underlying asset. As a result of this remoteness, the system lost the trust of market participants very quickly and accelerated the crisis, even where the underlying asset was of good quality.

### **Operational Risk**

Customized and complex products require extensive documentation and monitoring, which requires sound risk-monitoring infrastructure. Some who invest in structured products may not have the wherewithal to monitor and mitigate the associated operational risks. Reporting risk is also associated



with structured products, which require fair-value computation and proper accounting treatment of gains and losses. In a fast-evolving market, an institution can very quickly become exposed to additional operational risk associated with new products, and as this exposure aggregates across multiple investors, it can threaten the stability of the financial system.

### **Transparency**

As opposed to engineering professions where there is extensive testing in real-life situations and a long history of professional experience in the fields of civil, mechanical, or structural engineering, financial engineers do not have the luxury of a control environment for performing thorough testing. Since a new financial product gives a potential competitive edge to its inventor, there is less incentive to share the information with others and therefore less transparency in the process of innovation. Investment banks guard their products strictly, which means that any new product is subjected to less scrutiny by outsiders.

## **CHALLENGES FOR FINANCIAL ENGINEERING IN ISLAMIC FINANCE**

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Developing new financial instruments is no easy task. The success of financial engineering in conventional markets was not achieved overnight, but was the result of many years of preparation and incremental progress. Conventional markets had another advantage—the availability of a highly liquid fixed-income securities market. A steady supply of short- and long-term securities with minimal cost of entry and exit helped the development of new products in an arbitrage-free market. Innovation and product development were further boosted by advances in technology, with more computing power enabling the analysts to build complex models to solve complex equations.

Islamic financial markets face several challenges in introducing the process of financial engineering. Some of these challenges are discussed below.

### **Theoretical Foundation**

One of the major stimulants to rapid innovation in conventional financial markets was the breakthrough in financial theory. The theories of capital structure, portfolio diversification and option pricing laid the foundation for more-sophisticated solutions to complex problems. Although some theoretical work has been undertaken in Islamic finance, there are many areas, such as asset pricing, risk pricing, derivatives, and so on, which need further research. Without solid theoretical work and without a full understanding of the risk/return profiles it becomes difficult to apply financial engineering.

An economist cannot solve all theoretical issues without understanding the principles of the *Shari'ah* or without working closely with a *Shari'ah*

scholar. Therefore, it is essential that serious research efforts be made collectively to address the theoretical foundation of the system upon which a more sophisticated set of instruments can be built. This requires that all stakeholders who are interested in the further growth of the industry—primarily banks and governments—allocate the necessary resources.

### **Investment in Infrastructure**

Financial engineering and the development of new products are resource-intensive activities. All major conventional banks have dedicated departments to conduct background market research, product development, and analytical modeling. These activities require significant investments of financial and human resources. Conventional financial institutions can justify this because they are able to recover costs, in most cases, from the volume of business generated by their innovative products. The costs associated with the development of new products are further increasing as a result of the growing complexity of a business environment in which stiffer regulatory, accounting and reporting standards make greater demands.

Islamic financial institutions are generally small and thus unable to reap the benefits of the economies of scale. Alone, they cannot afford to invest substantial funds in research and development. However, given the importance of the subject, they should give serious consideration to making joint efforts to develop the basic infrastructure for introducing new products. Although collaboration is almost counterintuitive in a field where innovation often leads to a competitive edge, conducting basic research and development collectively may save some of the costs required to build this infrastructure individually. They could, for example, sponsor research into developing analytical models, computer systems and tools to analyze the risk and return on different *Shari'ah*-compatible instruments.

### **Collaboration and Cooperation**

Financial engineering is an area where IFIs can benefit from the greater experience of their Western counterparts. Conventional investment banks, which have already made heavy investments in the infrastructure for developing new products, can work for, or with, Islamic institutions to develop products geared specifically to the IFIs' requirements. The IFIs may find it beneficial to outsource the development aspects to conventional institutions and keep the marketing of the new products for themselves.

### **Cross-training**

*Shari'ah* scholars play a critical role in approving new financial products. While they may be masters in *Shari'ah* matters, their knowledge of business practices, economics and finance may be limited. Today's financial institutions work in a complex business environment, which puts the onus upon the *Shari'ah* scholars to be more vigilant and sympathetic to the needs

of institutions and their customers. They need to assume an active role in understanding the nature of business and banking. Special training institutions can be set up to develop targeted training for *Shari'ah* scholars in areas outside their expertise, and for economists and bankers in matters pertaining to *Shari'ah* law. Such cross-training will help each party to understand the other's point of view.

### **Standardization**

The introduction of new products can benefit greatly from the standardization of contracts and unification of standards across markets. *Shari'ah* scholars can play a positive role in this regard. Regulators can help in defining accounting, reporting and supervisory standards, which can help reduce the costs involved in introducing new products to different markets.

### **Judicial use of "Law of Necessity"**

It is observed that *Shari'ah* scholars tend to invoke the law of necessity (*dharoorah*) to accommodate pressing demands from bankers or customers. Extreme caution should be observed in making sure that a practice allowed under the law of necessity does not become a rule. Frequent use of such exceptions may not only contaminate the essence of the system, it may also raise suspicions in the minds of those who have put their trust in the system.

### **Check on *Shari'ah* Arbitrage**

In Islamic jurisprudence, the act of combining several contracts in a manner which creates an effect or behavior that is either prohibited or counterintuitive to the essence of Islam is called *hila* (artifice), and has been condemned throughout history. Such an act is the equivalent of regulatory arbitrage where an innovation is introduced to circumvent regulations. The industry and *Shari'ah* scholars will be watching closely to ensure that such acts are nullified.

A recent example of arbitrage is *tawarruq* (reverse *murabahah*) which creates a debt obligation by pretending a sale of a real asset which, in reality, does not change hands. This practice has been declared void by OIC *Shari'ah* scholars. Although it is still practiced in the market, its occurrence has declined considerably since the ruling in 2009.<sup>4</sup>

## **CONCLUSION**

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The scope of financial engineering and derivatives in Islamic finance will be determined by several factors. The most critical of these factors is how successfully the industry is able to adhere to the objectives of *Shari'ah*, which are the ultimate goal of each action.

Chapra (2008) compiles different views on these objectives and highlights those designed to promote the well-being of humans through

safeguarding their faith, self, intellect, posterity and wealth. He constructs a detailed system to demonstrate that each of these objectives provides the guidelines for economic development, social justice, good governance, and general human well-being irrespective of race, color, religion, and creed.

The development of financial engineering and derivatives will be governed by the objectives of *Shari'ah* and will, therefore, ensure that injustice in any form of inequity, exploitation, oppression and wrongdoing will not be acceptable.

The preservation of wealth and the protection of property rights will guide the innovation to promote the equitable distribution of income and wealth and to long-term sustainable economic development. The challenge for scholars will be to reinterpret the *Shari'ah* in the light of ever-changing social and economic circumstances but without sacrificing its core objectives.

The second critical factor is to create a balance between public good (*maslahah*) and the objectives of *Shari'ah*. With the increasing complexity and volatility of financial markets, it could be argued that there is a need for hedging to be permitted as a public good (keeping in mind the *Shari'ah* objective to protect wealth). Certain derivative products such as forwards, futures, swaps, and options provide protection against risks and, therefore, make a strong case of consideration under *maslahah*. The challenge would be how to approve a product which meets this need for public good without violating the core principles of Islam.

The third critical factor would be to focus on the essence rather than the form. Serious financial engineering should not permit any regulatory arbitrage (especially when it comes to *Shari'ah* arbitrage) and practices which are against the spirit of Islam and which do not promote genuine risk sharing in financial products and services. Innovation, rather than imitation or the reverse engineering of conventional products, should be given priority. The Islamic financial industry will have to develop products which discourage debt-like instruments and promote risk-sharing products.

The efficiency and benefits of a product should not be determined by the complexity of its payoffs or of the formulas to assess its value. Rather, they should be determined by transparency in design, clarity in payoffs, and closeness of ownership to the underlying asset. There should be a focus on simpler, more standardized, and more liquid products, which are less prone to unexpected changes in their likely performance and, therefore, are able to sustain liquidity during periods of stress.

Finally, although financial engineering should be encouraged in Islamic finance, its growth should be closely monitored to achieve the ultimate goals of *Shari'ah*. Further research is required on the permissibility of derivatives.

Alternative ways to mitigate and transfer risks—such as cooperative mechanisms, collective funds or solidarity funds—should be developed to contribute to the stability of the financial system.

Examples demonstrating the application of financial engineering techniques in the area of risk management and benchmarking can be found in Appendix C.

## APPENDIX C

# Potential Applications of Financial Engineering

**F**ollowing are a few examples demonstrating the application of financial-engineering techniques in the area of risk management and benchmarking. These examples use the basic instruments to develop new instruments that are currently not available in the market. It should be noted that the instruments discussed here are only examples and they should be taken with the qualification that the final approval and application rests with the *Shari'ah* experts.

### **SYNTHETIC CURRENCY FORWARD CONTRACT**

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The concept of arbitrage pricing and the ability to replicate a security synthetically has played a critical role in the development of derivatives and risk-management tools in conventional finance. Arbitrage is used extensively to demonstrate that in an efficient market two instruments with identical risk/return characteristics cannot have different prices. The ability to construct and to replicate a security or portfolio synthetically helped in the development of derivative products, as it was demonstrated that two portfolios—one with a derivative security and the other with plain vanilla securities—would have identical risk/return profiles in a world free of arbitrage. Such arbitrage principles and the techniques of financial engineering can be applied, using the basic building blocks of the Islamic financial system, for devising derivative instruments that are not currently practiced.

A currency forward contract is an agreement to buy or sell a foreign currency at a predetermined price at a predetermined future date. Islamic instruments permit similar forward contracts (future delivery at a pre-agreed price) but only in the case of commodities, provided certain conditions stated by the *Shari'ah* are followed. The Islamic forward contract, *bay' al-salam*, permits one party to purchase a commodity at a predetermined price for a future delivery and the purchaser is required to make full payment at

the time of contract. However, application of *bay' al-salam* to foreign currency is not permitted simply because Islam treats currency as a medium of exchange and not as a commodity. There are no other instruments that can be used to hedge against the volatility of the exchange rate.

The following section demonstrates how a currency forward contract may be constructed synthetically without a standard forward contract. The synthetic construction of a forward contract means that the payoffs are identical to a forward contract, but they are achieved through a set of different transactions executed in a certain sequence. These products can make significant contributions to risk management in Islamic financial markets, providing hedging against currency risk.

Take as an example an importer in an Islamic country who wants to hedge against the volatility of a foreign currency. In the absence of a currency forward contract, the importer will be exposed to risk arising from any appreciation in the value of the foreign currency. Assuming that there are no market frictions such as taxes, capital controls and transaction costs and that there are financial intermediaries who have access to both local and foreign money markets, a forward contract can be constructed synthetically using the *murabahah* contract, which results in a financial claim from the sale of a real asset. However, since the margin above cost (mark-up) is agreed upon in advance, the expected rate of return is pre-determined. The financial claim created in this fashion is similar to a zero-coupon fixed-income security or a certificate of deposit (CD) in conventional banking.

Suppose that the importer wants to hedge  $X$  amount of foreign currency obligation for a period of time ( $T$ ) from today ( $T_0$ ). Current market rates of return on a three-month *murabahah* contract in domestic and foreign markets are  $R_d$  and  $R_f$  respectively. The importer can approach a financial intermediary or Islamic bank to arrange for the purchase of  $X$  amount of foreign currency in the future.

The following steps can be taken by the financial intermediary to provide a currency hedge to the importer by taking positions in assets in foreign markets in collaboration with a local investor:

**On the date of the contract ( $T_0$ ):**

**Step 1:** Importer requests the bank to arrange for a currency forward contract for maturity  $T$ . The banker enters into a *jo'alah* contract with the importer to deliver  $X$  amount of foreign currency at the foreign exchange rate at time  $T$ . This contract allows the importer to hire the bank to provide a service; that is, to arrange or deliver currency at time  $T$  for a pre-determined fee.

**Step 2:** The banker finds an investor in the domestic market who is willing to participate in arranging a currency forward contract for maturity  $T$ . Or, the bank may use funds from an existing depositor's investment account as well. Let us assume that the expected rate of return in the local market at time  $T_0$  was  $R_d$ .

**Step 3:** The bank determines the amount in the foreign currency required today (at  $T_0$ ) to hedge  $X$  amount of foreign currency at time  $T$ . In other words, what is the present value of  $X$  amount of foreign currency given the expected rate of return? That should be equal to the value of a *murabahah* in foreign currency at time  $T_0$ , so that the cost plus the profit margin in the foreign market is equal to the required hedge amount of  $X$  in foreign currency at time  $T$ . Therefore, the amount required today to hedge  $X$  amount of foreign currency would be equal to  $x$  in foreign currency as shown below:

$$x = \frac{X}{(1 + R_f)}$$

**Step 4:** Local currency ( $L$ ) required at time  $T_0$  will be equal to  $x \times$  spot exchange rate between the local and the foreign currency. The bank invests  $L$  amount of local currency in foreign *murabahah* after converting  $L$  amount of local currency into  $x$  amount of foreign currency at the spot rate at  $T_0$ .

**Step 5:** The bank agrees with the importer to deliver  $X$  amount of foreign currency on maturity date  $T$  at rate  $F$ . The bank determines the rate  $F$  based on the rate-of-return differential between the domestic and foreign markets. In other words, the future rate  $F$  is a function of the expected rates of return on local and foreign *murabahah* for time  $T$ . The difference between domestic and foreign *murabahah* mark-up rates determine the discount/premium on forward rate. This rate  $F$  can also be called the unbiased predictor of the future spot rate, because if this rate is not the equilibrium rate, there is opportunity for arbitrage where the arbitrageur can make risk-less profit by taking offsetting positions in the market creating the arbitrage. In other words, the forward exchange rate ( $F$ ) will be determined in such a way that the forward discount/premium on the currency is equal to the differential of expected rates of return on *murabahah* contracts of equal risk in domestic and foreign capital markets. This rate ( $F$ ) is not only the best estimate of the future spot exchange rate, but is also an arbitrage-free forward rate for the currency.

**At the date of delivery ( $T$ ):**

**Step 6:** The bank receives  $X$  amount of foreign currency against the *murabahah* investment. The importer buys  $X$  amount of foreign currency by paying  $X \times F$  amount of local currency to the bank. Since the bank initially invested  $L$  amount, the rate of return to the bank or the investor would be equal to  $R_d$ , or the same as the bank or the investor would have earned by investing in local *murabahah*.

This synthetic forward contract is fully backed by an Islamic investment in the form of a *murabahah*. As a result, the bank or the investor earns  $R_d$  on the investment. The importer benefits from the exchange rate hedge in case the future exchange rate moves unfavorably.

The following illustrates the calculations involved in a synthetic forward contract and the profit made by the bank or the investor in our example:

Local currency:	Euro (€)
Foreign Currency:	US Dollar (\$)
Period:	3 months
Rate of Return on 3-month <i>murabahah</i> in domestic market (R€):	10%
Rate of Return on 3-month <i>murabahah</i> in foreign market (R\$):	5%
Spot Rate:	€0.85/\$
Amount to hedge:	€1,000,000.00

Amount of investment required in foreign currency at settlement date ( $T_0$ ):

$$\frac{\text{Hedge Amount}}{(1 + R_s)} = \frac{1,000,000}{(1.05)} = \$952,381$$

Amount of investment required in local currency at settlement date ( $T_0$ ):

$$\text{Foreign Amount} \times \text{Spot Rate} = \$952,381 \times 0.85 = \text{€}809,524$$

Convert €809,524 @ €0.85/\$ to \$952,381 and invest the proceeds in \$ *murabahah* with expected rate of return = 5 percent.

Arbitrage-free forward rate (F) quoted to importer:

$$F = \text{Spot} \times \frac{(1 + R_{\text{Euro}})}{(1 + R_{\$})} = 0.85 \times \frac{1.1}{1.05} = 0.8905 / \$$$

Value of *murabahah* at maturity (T):

$$\text{Investment amount} \times (1 + \text{Rate of Return}) = \$952,381 \times (1.05) = \$1,000,000$$

The bank received \$1,000,000 from foreign *murabahah* investment and sold \$1,000,000 to the importer at €0.8905/\$ and received €890,500.00.

The bank or investor's rate of return:

$$\frac{\text{Amount at Maturity}}{\text{Initial Investment}} - 1 = \frac{890,500}{809,524} - 1 = 10\%$$

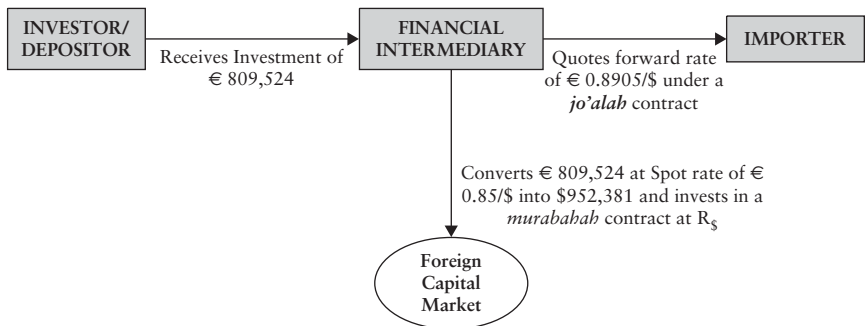


The importer is able to hedge his/her currency risk and the bank/investor has earned a 10 percent return, which is also equal to the rate of return on domestic *murabahah*, indicating the bank/investor's opportunity cost.

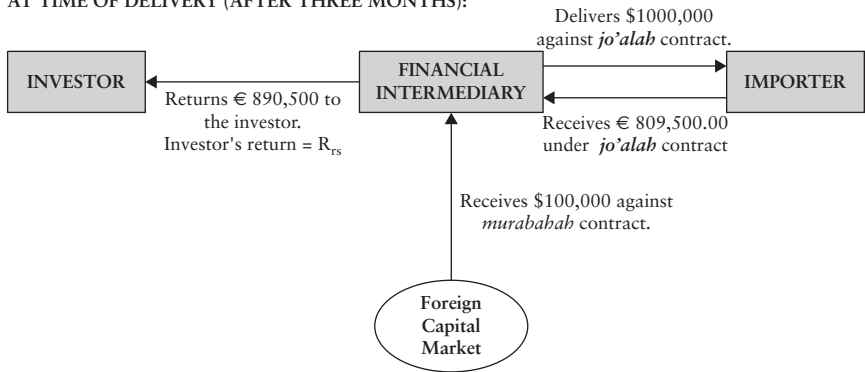
The above example is a simple demonstration of the construction of a synthetic currency forward contract. In a capital market where there are large numbers of users and providers of capital, a financial intermediary can serve the purpose of matching the needs of both entrepreneurs and investors. The financial intermediary that has wider access to several money and capital markets can perform the function more efficiently by standardizing the products, enhancing credit through underwriting (*kifala*) and offering clients risk management services for a reasonable fee (in the form of *jo'alah*).

Figure AC1 illustrates the construction of the synthetic forward contract in our example.

AT TIME OF CONTRACT ( $T_0$ ):



AT TIME OF DELIVERY (AFTER THREE MONTHS):



**FIGURE AC1** Construction of a synthetic forward contract

**Note:** Illustration does not take into account any transaction cost or financial intermediary's fees.

## CURRENCY SWAP

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Currency swaps are one of the most popular applications of financial engineering and the market for them has grown exponentially since their introduction in the early 1980s. The underlying concept is to exploit a comparative advantage in a particular market to raise capital at favorable rates and then agreeing with another party to exchange cash flows according to a predetermined schedule for cash flows in another currency. As an off-balance-sheet instrument, a currency swap is frequently used to hedge against currency risks, to lower funding costs through arbitrage in different capital markets, and to gain access to otherwise inaccessible emerging markets.

A currency swap can help an institution reduce its exposure to a particular currency by allowing it to swap existing assets or liabilities for more desirable ones. For example, an Islamic financial institution may develop a comparative advantage in the market for assets or liabilities in a particular currency and this advantage can lead to increased exposure in a particular currency. Currency swaps enable financial institutions to manage currency exposure and also achieve better asset/liability management, which can ultimately reduce the overall financial risk.

Since a currency swap is an agreement to exchange cash flows in accordance with a fixed schedule, it can also be viewed as a series of currency forward contracts for each period of the schedule. Currency swaps are currently not practiced in Islamic financial markets, mainly because of the prohibition on currency trading in the forward markets. However, there are other ways of going about it. Currency swaps were a by-product of a practice known as “parallel loans,” which was followed by several corporations to avoid regulatory constraints. With this practice, both a parent company and its foreign subsidiary borrow in their respective markets (foreign and local currencies) and then swap the proceeds internally between them. In this way, a currency swap can be viewed as an exchange of two bonds (loans) in different currencies.

The following sections describe two different ways to construct a currency swap that may be acceptable in the Islamic financial market. The first method involves a partnership with a financial intermediary, and the second is based on the exchange of *sukuk* proceeds.

### Partnership-based Currency Swap

Suppose that an IFI has accumulated a portfolio of *ijarah* assets in a currency that is different from the currency of its liabilities (funding side). In order to reduce its exposure to a single currency on its assets side, the IFI wants to swap a portion of its portfolio into the currency of its liabilities in order to improve its asset/liability management. For the sake of simplicity, the example is reduced to a single *ijarah* asset, but the principle can be extended to a pool of assets through securitization.

A financial intermediary can arrange such currency swaps through the following steps:

**Step 1:** The financial intermediary and the financial institution (A) agree to enter into a partnership where the financial intermediary will buy that portion of the portfolio which the financial institution would like to swap: in our case, the *ijarah*-based asset denominated in Japanese yen (¥).

**Step 2:** The financial intermediary agrees to pay for the assets through equity participation certificates issued by the financial intermediary in a foreign currency; that is, US dollars (\$).

**Step 3:** In order to be fully hedged, the intermediary enters into an identical agreement with another financial institution (B), which is holding an *ijarah* asset in the foreign currency (\$) and desires to swap its assets to ¥. (A) and (B) exchange the principal amounts in the respective currencies equal to the respective asset values at the time of the settlement.

**Step 4:** All future cash flows of party (A) in ¥ will be passed on to the financial intermediary as part of the partnership agreement.

**Step 5:** All future cash flows of party (B) in \$ will be passed on to the financial intermediary as part of the partnership agreement.

**Step 6:** At each future cash flow date, the financial intermediary will pass the ¥ cash flows which it received from party (A) to party (B), and all \$ cash flows which it received from party (B) to party (A). This will effectively convert each party's assets from one currency to the other. At maturity, the principal amounts equal to asset values will be exchanged back in the original currencies. The intermediary earns fee income for arranging and servicing this agreement.

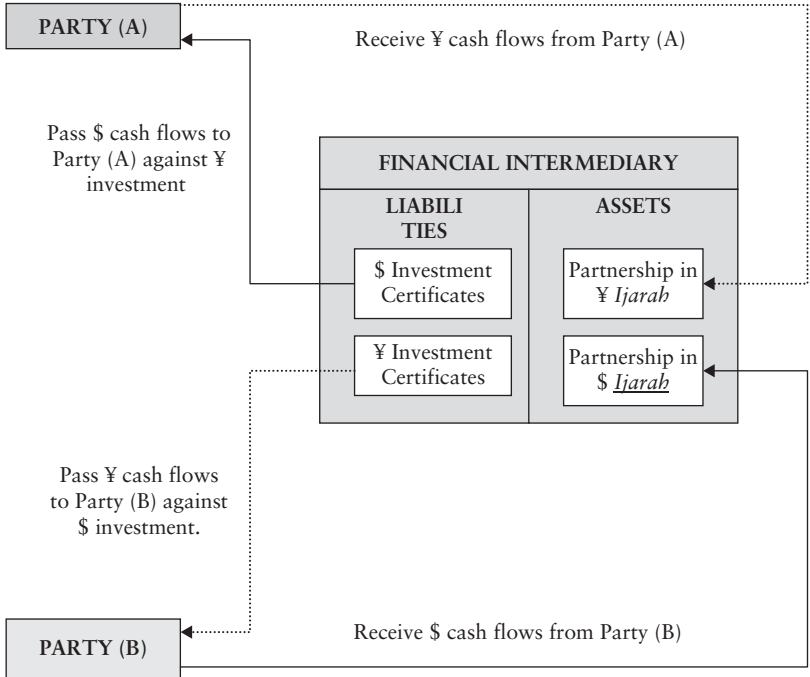
Figure AC2 illustrates the flows and the role played by the financial intermediary.

The main difference between this and a conventional currency swap is that the financial intermediary becomes a partner in the assets of each financial institution and the cash flows are fully backed by the cash flows on each underlying asset. Where in a conventional currency swap, the financial intermediary underwrites the credit risk only, in the Islamic version, the financial intermediary backs each agreement with a real asset in addition to underwriting the credit risk.

This, of course, is a simplified version for illustrative purposes and finding assets of the same maturity and equivalent value is not easy. One way to reduce this problem would be to collect a pool of assets of similar maturity and to securitize the assets through *sukuk*, which can be swapped as one security. This idea is further refined in the second method.

### **Sukuk-based Currency Swap**

As mentioned earlier, a currency swap can be viewed as two parallel streams of cash flows from two bonds in two different currencies which the parties agree to swap. Since Islamic bonds, *sukuk*, are similar to conventional



**FIGURE AC2** The role of the intermediary in a partnership-based currency swap

bonds in their payoffs, a currency swap can be constructed by utilizing the *sukuk* structure.

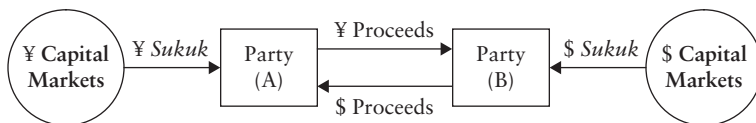
For example, suppose party (A) is well-established and well-known in ¥ capital markets and is thus able to raise funds through *sukuk* in ¥ at attractive rates. However, its funding objectives are to borrow in \$ to match its liabilities but its cost of funding in \$ is higher. At the same time, party (B) is able to raise funds through *sukuk* in the \$ market at attractive rates because of its established track record and credit standing, but its funding objectives are to borrow in ¥. Following the theory of comparative advantage, both parties issue *sukuk* in the respective markets in which they have the comparative advantage and then agree to swap cash flows to achieve their respective funding objectives.

The following steps can be taken to create a currency swap using *ijarah*-based *sukuk*:

**At the time of settlement ( $T_0$ ):**

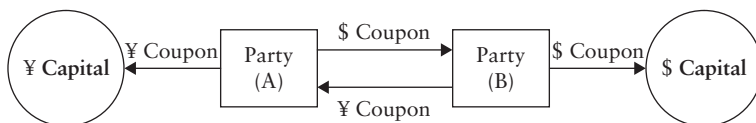
**Step 1:** Party (A) issues *ijarah sukuk* in ¥, and party (B) issues an *ijarah sukuk* in \$. The *ijarah sukuk* are selected in this case, rather than ones that are *salam*-based, because they allow the possibility of trading in the secondary markets.

**Step 2:** With the help of a financial intermediary, both parties agree to enter into a currency swap where (A) promises to take (B)'s liability in \$, and (B) promises to take (A)'s liability in ¥. At the time of settlement, both parties exchange the proceeds from the *sukuk* each received from the market.



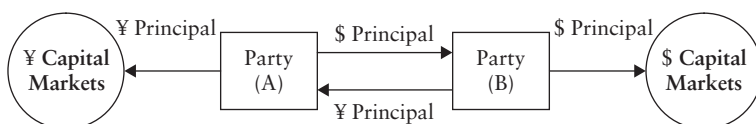
**At each *sukuk* coupon payment:**

**Step 3:** At each coupon period, (A) pays \$ coupons on (B)'s *sukuk* and receives ¥ cash flows from (B), which are used to pay to the *sukuk* investors. Similarly, (B) pays ¥ to (A) in exchange for \$ coupons which are passed on to the *sukuk* investors.



**At maturity (T):**

**Step 4:** The principal amounts of the *sukuk* in the respective currencies are exchanged. Party (A) receives ¥ principal from (B), which is used to pay off the ¥ *sukuk* issued by (B). Similarly, (B) receives \$ principal from (A), which it used to pay back the \$ *sukuk*.



## RATE-OF-RETURN SWAP

The interest-rate swap market is the largest over-the-counter (OTC) derivative market, which indicates the importance and prevalence of this instrument. The idea behind an interest rate swap is to exchange cash flows in the same currency according to a predetermined schedule. The main purposes of entering into such an agreement are to lower the cost of funding, to enhance yield, or to manage the interest rate risk. The most common type is a fixed-to-floating rate swap, where one party agrees to swap fixed-rate coupon payments against receipt of floating-rate coupon payments for a predetermined notional amount.

The concept described above to develop currency swaps using *sukuk* can be applied to developing an Islamic instrument similar to the rate-of-return swap, with the main difference being that parties will agree to

exchange the rate of return on one asset with another, rather than exchanging interest rates. Rate-of-return swaps are different from currency swaps in that there is no exchange of principal, since the cash flows belong to the same currency. Note that *ijarah*-based *sukuk* are suitable for constructing a rate-of-return swap because they are available in both fixed- and floating-return formats.

This rate-of-return swap can be constructed as follows:

**Step 1:** Party (A) has a comparative advantage in raising funds through fixed-rate *sukuk*, but would like to convert this liability into a floating-rate liability to match its assets. Similarly, (B) has a comparative advantage in raising funds through floating-rate *sukuk*, but would prefer to have a fixed-rate liability to match its assets.

**Step 2:** (A) decides to issue fixed-rate *sukuk* and (B) issues floating-rate *sukuk*. Both parties enter into an agreement to exchange cash flows on the coupon dates. This could be an agreement to assume the other party's liability. Since both *sukuk* have the same amount of proceeds in the same currency, there is no exchange of principal cash flows.

**Step 3:** On each coupon period, (A) pays floating-rate payments to (B) against receipt of fixed-rate coupons, which are ultimately passed on to pay the *sukuk* holders. For (A), the net effect is a floating-rate liability. Similarly, (B) pays fixed coupons against receipt of floating coupons from (A), which are passed on to the holders of the floating-rate *sukuk*.

**Step 4:** At maturity, no principal exchange takes place. Both parties make payments to their respective *sukuk* holders.

The following example illustrates cost saving through an interest rate swap.

Costs before Swap	Party (A)	Party (B)
Fixed-rate <i>sukuk</i> :	5%	5.5%
Floating-rate <i>sukuk</i> :	[Islamic Index] +25 bps	[Islamic Index] -25 bps

Based on the comparative advantage, (A) decides to issue fixed-rate *sukuk* at 5 percent and (B) decides to issue floating-rate *sukuk* at [Islamic Index] -25 bps.

Costs After Swap	Party (A)	Party (B)
Receives from counterparty	5.0%	[Islamic Index] -25 bps
Pay to counterparty	[Islamic Index] - 25 bps	5.0%
Pay to <i>sukuk</i> holders	5%	[Islamic Index] -25 bps
Net Funding Cost	[Islamic Index] -25 bps	5%
Net Savings (difference in before and after cost)	50 basis points	50 basis points

In this example, both parties agree to exchange cash flows to match their obligations to the *sukuk* holders. However, in reality, the party with the better credit quality tends to charge the other party an additional cost to reduce its own overall cost. Since the charging of an additional cost to assume the other party's liability may raise *Shari'ah* objections, no additional cost in the swap is incorporated. We leave this issue to be discussed by *Shari'ah* scholars.

## DEVELOPMENT OF AN ISLAMIC BENCHMARK

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The availability of an efficient, frequently quoted and globally accessible reference rate for pricing assets and a benchmark for evaluating portfolio performance is vital to the success of today's financial markets. Islamic financial markets are no exception to this and their growth and development are similarly dependent on an efficient and stable benchmark. While Islamic financial markets have made considerable progress in the last few decades, the issue of benchmarks has received little attention to date. In the absence of a suitable equity-based benchmark compatible with the principles of the Islamic financial system, markets have often resorted to the use of interest-based benchmarks such as LIBOR to determine mark-up rates in trade finance, to price assets and to evaluate portfolio performance.

A model developed by Haque and Mirakhor (1997) addressed the design of an equity-based index, which fully conforms to Islamic principles and can ultimately serve as a benchmark for issuing government paper.<sup>5</sup> Their approach is based on a simple argument; namely, that government paper collateralized against its development and infrastructure projects which do qualify for equity-participation should not carry a return which is anyway less than the private-sector projects of similar risk. Therefore, given an efficient index to measure the return on private-sector security, governments can issue paper such as the National Participation Paper (NPP) to finance their development projects. The return on such an index needs to be adjusted for a risk premium, which would be negative for the government paper because governments are assumed to be insulated from credit and default risks.

The model argues that the principles of Islam dictate that the return on the financial sector in the economy should be determined by the return on the real sector of the economy. The return on the real sector could be derived from the expected growth of the dominant private-sector productivity as it is the main contributor to a country's nominal GDP. A desirable index needs to be efficient in terms of its ability to eliminate any arbitrage opportunity, to discourage speculative behavior and to be allocationally and operationally efficient. However, the fact that financial markets in the developing Islamic countries are not yet fully developed means that an index based on a single indicator may not prove to be efficient. However, a weighted index of different indicators representing activity in domestic, international, private and public sectors can be more robust, efficient and stable.

**TABLE AC1** Islamic index representing equity returns

$I = w1WI + w2LSI + w3PPI + w4ROG$
where
I = Index representing rate of return on the private sector
w1, w2, w3 and w4 are weights for each indicator. Weights to be determined by each market to match individual market characteristics.
WI = An international stock market index such as the MSCI emerging-market index.
LSI = Domestic market performance index, e.g. stock market index, average q for the economy, return on equity (ROE), etc.
PPI = A weighted average of returns in commercial participation paper market as it develops.
ROG = Measure of the rate of return on government investments in developmental and infrastructure projects against which government paper is issued.

Table AC1 gives a summary of how a weighted composite index, which represents equity returns in an Islamic economy, can be constructed. The inclusion of a local stock-market index is natural, but not without certain reservations. Depending on the degree of that market’s depth, breadth and liquidity determining the competition and efficiency of the market, the domestic stock market index may or may not be included. In the case of a shallow market, other factors influencing investment decisions, such as the economy’s *q* ratio, price/earnings (PE) ratio and dividend yield or return on equity (ROE), can be included.

Basing the index on the domestic stock market or local indicators alone is not recommended because of the lower degree of development of domestic equity markets in Islamic countries. In order to broaden the index, it is advisable to include an external index representative of the regional or international financial environment. Given recent economic liberalization, globalization and integration of the international capital markets, it is reasonable to assume that the domestic rate of return will reflect the returns worldwide. It is desirable that the selected external index is easily monitored, relatively stable and broadly in line with the domestic economy.

**ENDNOTES**

1. Jenkinson, Penalver and Vause (2009) identify five areas of potential weakness during the crisis: incomplete information; alignment of incentives; liquidity in financial markets; robustness of market infrastructure; and system dynamics. There may be insufficient information to gauge the risk in new financial instruments. Indeed, information can get lost when a chain of parties is involved in the creation of new financial instruments. If these parties do not retain an economic



interest in the performance of the instrument, its inherent risk can grow as incentives to screen and monitor weaken. In addition, the benefits of tailoring the risk profile to meet the demands of specific investors can be offset by the poor liquidity that might apply to a bespoke component.

2. Ibid.
3. Ibid.
4. OIC Resolution 179 (19/5/2009).
5. Haque and Mirakhor (1997).

## CHAPTER 13

# Risk Management

**A**s the banking business has changed significantly in the last two decades, the nature of the risks faced by financial institutions has also changed. Where three decades ago these were primarily credit and market risks only, today's financial institution is exposed to a whole array of new risks and this list is expanding. Several factors are responsible for this changed scenario:

- **Increased market volatility:** Financial institutions first realized the importance of risk management after the breakdown of the Bretton Woods system of fixed exchange rates, which led to significant volatility in the foreign exchange and interest-rate markets. Since then, volatility in the markets and the subsequent demand for risk management products has become a permanent feature of the markets.
- **Financial innovations:** Financial innovations and rapid developments in the derivatives market have increased the complexity of managing financial institutions. Innovative products have appeared on both sides of the balance sheet and each new product brings its own unique risk/return profile, which ultimately affects the risk profile of the institution. The risk/return characteristics of some of the new instruments are complex and are subject to highly volatile markets, exposing banks to new or higher degrees of risk.
- **Shift in banking business:** There has been a permanent shift away from traditional lending business towards fee-earning activities. The expanded role of money and capital markets has changed the nature of intermediation by moving it away from formal institutions to direct access to the market. The emergence of institutional investors such as mutual funds has taken a significant share of the market from traditional banking business.
- **Increased competition:** Competition has increased, making it difficult for small banks to compete as a result of the increasing costs of doing business and the high costs associated with managing risks. A wave of consolidation of financial institutions was witnessed in industrial countries in the late 1990s, making the need for risk management even more critical.

- Regulatory environment: In the wake of a series of financial crises, from the Third World debt crisis of the 1980s to the East Asian crisis of the 1990s, there has been greater awareness of the need for coordinated regulation and supervision of financial institutions, with a special focus on risk measurement and management and prudential capital requirements. There is a greater emphasis on coordinated efforts at the global level to harmonize standards, promote transparency in the system and to combat money-laundering and the financing of terrorism.

These developments have increased the need for risk measurement, management and controls. A comprehensive framework of risk management is applicable to conventional and Islamic banks alike. Research and experience in the past two decades have resulted in a much deeper understanding of the issues relating to risk management and, consequently, well-established principles of risk management have emerged. The process of risk management is a two-step process. The first step is to identify the source of the risk; that is, to identify the leading variables causing the risk. The second step is to devise methods to quantify the risk using mathematical models, in order to understand the risk profile of the instrument. Once a general framework of risk identification and management is developed, the techniques can be applied to different situations, products, instruments and institutions.

The absence of a developed risk management framework in Islamic finance has a significant impact on the current and future growth of the market because:

- A *Shari'ah*-compliant firm will lose its business competitiveness because of its inability to handle variability in its costs, revenues, and profitability through active hedging of financial risk.
- A firm without active risk management will be perceived as a high-risk firm and thus will be subject to higher funding costs and to a higher expected rate of return.
- There will be fewer optimal investment and diversification opportunities.
- The firm will be subject to a high risk of financial distress, especially during a system-wide crisis.

All of these factors will lead to increased riskiness for the investors and their wealth.

Having a robust risk management framework can also help Islamic banks reduce their exposure to risks, and enhance their ability to compete in the market. A reduction in each institution's exposure will reduce the overall systemic risk. Therefore, it is necessary that IFIs have a comprehensive risk management and reporting process to identify, measure, monitor, manage, report and control different categories of risks. This process should also pay special attention to compliance with *Shari'ah* rules and principles.

**TABLE 13.1** Banking risk exposures

Financial risks	Operational risks	Business risks	Event risks
Balance sheet structure	Internal fraud	Macro policy	Political
Income statement structure & profitability	External fraud	Financial infrastructure	Contagion
Capital adequacy	Employment practices and workplace safety	Legal infrastructure	Banking crisis
Credit	Clients, products and business services	Legal liability	Other exogenous
Liquidity	Damage to physical assets	Regulatory compliance	
Market	Business disruption and system failures (technology risk)	Reputational & fiduciary	
Interest rate	Execution, delivery and process management	Country risk	
Currency			

Source: van Greuning (2008)

Banks are subjected to a wide array of risks in the course of their operations, as illustrated by Table 13.1. In general, banking risks fall into four categories: financial, operational, business, and event risks. Any of these risk categories can be further divided into sub-categories.

Financial risks are subject to complex interdependencies that may significantly increase a bank's overall risk profile. For example, a bank engaged in foreign currency business is normally exposed to currency risk, but will also be exposed to risks such as liquidity, credit, and re-pricing if it carries open positions or mismatches in its forward book. Operational risks are related to a bank's overall organization and the functioning of its internal systems, including computer-related and other technologies; compliance with bank policies and procedures; and measures against mismanagement and fraud. Business risks are associated with its business environment, including macro-economic and policy concerns, legal and regulatory factors, and the overall financial sector infrastructure such as payment systems and auditing professions. Event risks include all types of exogenous risks, which, if they were to materialize, could jeopardize the bank's operations or undermine its financial conditions and capital adequacy.

**TABLE 13.2** Theoretical balance sheet of an Islamic bank based on maturity profile and functionality

Panel A. Based on maturity profile	
Assets	Liabilities
Short-term trade finance (cash, <i>murabahah</i> , <i>salam</i> )	Demand deposits ( <i>amanah</i> )
Medium-term investments ( <i>ijarah</i> , <i>istisna'</i> )	Investment accounts ( <i>mudarabah</i> )
Long-term partnerships ( <i>musharakah</i> )	Special investment accounts ( <i>mudarabah</i> , <i>musharakah</i> )
Fee-based services ( <i>jo'alah</i> , <i>kifala</i> , and so forth)	Reserves
Non-banking assets (property)	Equity capital
Panel B. Based on functionality	
Assets	Liabilities
Cash balances	Demand deposits ( <i>amanah</i> )
Financing assets ( <i>murabahah</i> , <i>salam</i> , <i>ijarah</i> , <i>istisna'</i> )	Investment accounts ( <i>mudarabah</i> )
Investment assets ( <i>mudarabah</i> , <i>musharakah</i> )	Special investment accounts ( <i>mudarabah</i> , <i>musharakah</i> )
Fee-based services ( <i>jo'alah</i> , <i>kifala</i> , and so forth)	Reserves
Non-banking assets (property)	Equity capital

Source: van Greuning and Iqbal (2008)

An IFI is also subject to all of these risks to varying degrees. Its operational, business, and event risks will be similar to those of its conventional counterparts and, therefore, do not require any special treatment and discussion here. However, the nature of its financial risk would be different and it is, therefore, important to understand the key differences in the risk profiles of intermediaries in the respective systems.

Table 13.2 presents a stylized balance sheet of an Islamic bank, displaying different activities and financial instruments. It serves as a good starting point for understanding the dynamics of the risks inherent in Islamic banks. Panel A classifies assets and liabilities based on the maturity profile of different instruments. Panel B provides an alternative view based on the functionality and purpose of different instruments. Some instruments, such as *ijarah* and *istisna'*, can be used across different maturity groups. Although several Islamic banks organize their financial statements on the basis of functionality, a maturity-based view of the balance sheet is important as it helps to understand exposure at the institutional level.

Realizing the significance of risk management, in December 2005 the Islamic Financial Services Board (IFSB) issued a comprehensive standards

document on risk management, identifying the different risks and listing 15 guiding principles of risk management for institutions offering Islamic financial services.

Figure 13.1 presents an overview of the risk profile for operating an IFI. Risks are grouped into four broad categories: financial, business, treasury, and governance risks. While these categories are also applicable to conventional finance, there are risks specific to Islamic banks and financial institutions arising from the different nature of the intermediation, products and constitution of the balance sheet. The major risks are discussed below.

## FINANCIAL RISKS

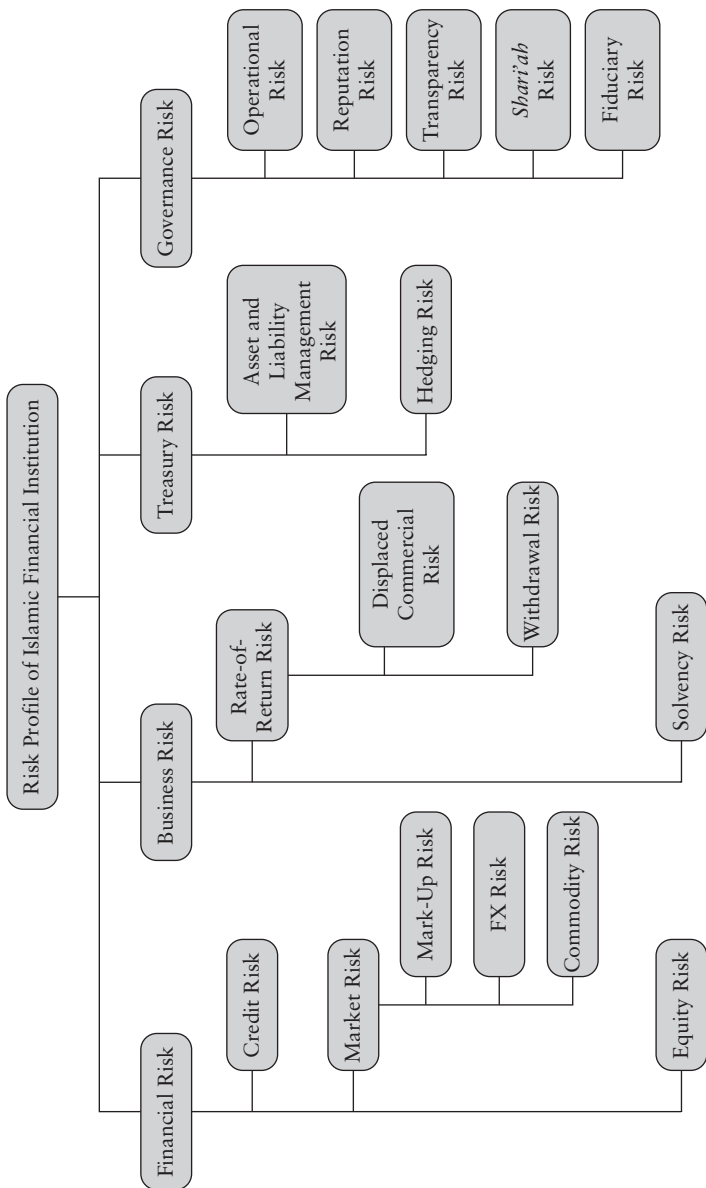
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Financial risks are the exposures that result in a direct financial loss to the assets or the liabilities of a bank. In the evolution of the risk management discipline, financial risks were the first to appear in the discussion and policy making. Both conventional and Islamic financial institutions are exposed to credit and market risks, but Islamic financial institutions are also exposed to equity investment risk.

### Credit Risk

Credit risk is the potential risk that a counterparty will fail to make payments on its obligations in accordance with the agreed terms. It also includes the risk arising in the settlement and clearing of the transactions. Credit risk is present to varying degrees in almost all of the instruments and there are many techniques to mitigate such risk. Traditional banking business based on lending operations is considered a credit-risk business since the bank's ability to minimize credit risk is the source of its profitability. In the case of IFIs, where lending is replaced with investments and partnerships, the importance of credit-risk management becomes more critical. The unique characteristics of the financial instruments practiced by Islamic banks have special credit risks such as the following:

- In the case of *murabahah* transactions, Islamic banks are exposed to credit risks when the bank delivers the asset to the client but does not receive payment from the client in time. In the case of a non-binding *murabahah*, where the client has a right to refuse the delivery of the product purchased by the bank, the bank is further exposed to price and market risks.
- In *bay' al-salam* or *istisna'* contracts, the bank is exposed to the risk of failure to supply on time or to supply at all, or failure to supply the quality of goods as contractually specified. Such failure could result in a delay or default in payment, or in delivery of the product, and can expose Islamic banks to financial losses of income as well as capital.
- In the case of *mudarabah* investments, where the Islamic bank enters into the contract as *rabb-ul-mal* (principal) with an external *mudarib* (agent),



**FIGURE 13.1** Overview of risk profile of an IFI

in addition to the typical principal/agent problems, the Islamic bank is exposed to an enhanced credit risk on the amounts advanced to the *mudarib*. The nature of the contract is such that it does not give the bank appropriate rights to monitor the *mudarib* or to participate in the management of the project, which makes assessment and management of the credit risk difficult. The bank is not in a position to know and decide how the activities of the *mudarib* can be monitored accurately, especially if claims of losses are made. This risk is especially present in markets where information asymmetry is high and there is low transparency in financial disclosure by the *mudarib*.

Managing credit risk is further complicated by some additional externalities. In the case of default by the counterparty, Islamic banks are prohibited from charging any accrued interest or imposing any penalty, except in the case of deliberate procrastination. This can be misused by clients who may delay the payment, since they know that the bank will not impose extra charges. During the delay, the bank's capital is not productive and its investors/depositors are not earning any income. Another example is where the bank's share in the capital invested through a *mudarabah* or *musharakah* contract is transformed into a debt obligation in the case of proven negligence or misconduct of the *mudarib* or the *musharakah*'s managing partner. As a result, the rules to recover a debt are applied, which are different from the rules of *mudarabah* and *musharakah* investment.

Risk mitigation techniques used by Islamic banks for credit risk do not differ much from those used by conventional banks. Risk measurement can be achieved by maintaining good-quality data on past performances of the counterparty and by determining the probability of default. In many developing countries where there are no formal institutions to maintain credit data, banks often rely on the client's track record with the bank. In the absence of rating agencies and public disclosures, information about a client's creditworthiness has to be gathered through informal sources and local community networks.

Using collateral and pledges as security against credit risk is a common practice among all Islamic banks. The bank might ask the client to post additional collateral before entering into a *murabahah* transaction. In some cases, the subject matter of the contract is accepted as collateral. Posting collateral as security is not without difficulties, especially in developing countries. Typical problems include the illiquidity of the collateral or the inability of the bank to sell the collateral, and difficulties in determining the fair market value on a periodic basis. The most important of these, however, are the legal hindrances and obstacles in taking possession of the collateral. Due to weak legal institutions and slow processing, it becomes difficult for the bank to claim the collateral. In addition to collateral, personal and institutional guarantees are also accepted to minimize credit risk.



### **IFSB PRINCIPLES OF CREDIT RISK**

**Principle 2.1:** [Islamic Financial Institutions] shall have in place a strategy for financing, using the various Islamic instruments in compliance with *Shari'ah*, whereby it recognizes the potential credit exposures that may arise at different stages of the various financing agreements.

**Principle 2.2:** [Islamic Financial Institutions] shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument.

**Principle 2.3:** [Islamic Financial Institutions] shall have in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument.

**Principle 2.4:** [Islamic Financial Institutions] shall have in place *Shari'ah*-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.

### **Market Risk**

Market risk for a financial institution arises in the form of unfavorable price movements such as yields (rate-of-return risk), benchmark rates (interest rate risk), foreign exchange rates (FX risk), equity and commodity prices (price risk) which have a potential impact on the financial value of an asset over the life of the contract. Islamic banks are further exposed to market risk arising from the volatility in the values of tradable, marketable or leaseable assets. The risks relate to the current and future volatility of market values of specific assets from different risk factors that include the following:

**Mark-up Risk** Islamic banks are exposed to mark-up risk as their mark-up rate used in *murabahah* and other trade-financing instruments is fixed for the duration of the contract while the benchmark rate may change. This means that the prevailing mark-up rate in the market may increase beyond the rate the bank had fixed in a contract and therefore the bank is unable to benefit from any increase. This is especially applicable to the *murabahah* contract, where the mark-up rate is fixed at the time of the contract. In the absence of any Islamic index of rate of return, Islamic banks often use LIBOR as the benchmark, which aligns their market risk closely with the movements in LIBOR rates.

**Price Risk** In the case of *bay' al-salam*, Islamic banks are exposed to commodity price volatility during the period between the delivery of the commodity and the sale of the commodity at the prevailing market price. This risk is

similar to the market risk of a forward contract if it is not hedged properly. In order to hedge its position, the bank may enter into a parallel (offsetting) *bay' al-salam* contract, leaving itself exposed to price risk if there is default on the first contract and the bank is obligated to deliver on the second contract.

**Leased Asset-value Risk** In the case of an operating *ijarah*, the bank is exposed to market risk over the life of the contract arising from a reduction in the residual value of the leased asset at the expiry of the lease term or, in the case of early termination, due to default.

**FX Risk** The movement of foreign exchange rates is another transaction risk arising from the deferred trading nature of some contracts offered by Islamic banks, as the value of the currency in which receivables are due may depreciate or the currency in which payables are due may appreciate.

**Securities Price Risk** With an increasing market for Islamic bonds (*sukuk*), Islamic banks invest a portion of their assets in marketable securities. However, the prices of such securities are exposed to current yields. Similar to a fixed-income security, the prices go down as yields go up and vice versa. Islamic banks holding such securities will be exposed to volatility in yields, unless they hold the security till maturity. Furthermore, the secondary market for such securities may not be very liquid, exposing the banks to distorted prices in an illiquid market.

### IFSB PRINCIPLES OF MARKET RISK

**Principle 4.1:** [Islamic Financial Institutions] shall have in place an appropriate framework for market risk management (including reporting) in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.

### Equity Investment Risk

IFIs are exposed to equity investment risk in profit/loss-sharing investments on the assets side. These include partnership-based *mudarabah* and *musharakah* investments. Typical examples of equity investments are holdings of shares in the stock market, private-equity investments, equity participation in specific projects or syndication investment.

This risk is unique to IFIs because conventional commercial banks do not invest on the basis of equity-based assets. Equity investments can lead to volatility in the financial institution's earnings arising from liquidity, credit, and market risks associated with equity holdings. Although there is credit risk in equity-based assets as discussed earlier, there is also considerable financial risk of losing capital invested as a result of business losses.

### IFSB PRINCIPLES OF EQUITY INVESTMENT RISK

**Principle 3.1:** [Islamic Financial Institutions] shall have in place appropriate strategies, risk management and reporting processes in respect of the risk characteristics of equity investments, including *mudarabah* and *musharakah* investments.

**Principle 3.2:** [Islamic Financial Institutions] shall ensure that their valuation methodologies are appropriate and consistent, and shall assess the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the institution and the *mudarib* and/or *musharakah* partners.

**Principle 3.3:** [Islamic Financial Institutions] shall define and establish the exit strategies in respect of their equity investment activities, including extension and redemption conditions for *mudarabah* and *musharakah* investments, subject to the approval of the institution's *Shari'ah* Board.

Some of the distinct features of equity investment risk are:

- The nature of equity investment requires enhanced monitoring measures to reduce informational asymmetries. These include proper financial disclosures, closer involvement with the project, transparency in reporting and supervision during all phases of the project from appraisals to completion. Therefore, Islamic banks need to play an active role in the process of monitoring, in order to mitigate this risk.
- Both *mudarabah* and *musharakah* are profit/loss-sharing contracts and are subject to loss of capital despite proper monitoring. The degree of risk in equity investments is higher than in other investments and, therefore, Islamic banks should take extreme care in evaluating and selecting the projects in order to minimize any potential losses.
- Equity investments (other than stock market investments) do not have secondary markets and therefore an early exit is costly. The illiquidity of such investments can cause financial losses to the bank.
- Equity investment may not generate a steady income, and capital gain might be the only source of return. This unscheduled nature of cash flows can pose difficulties for the Islamic banks in forecasting and managing the cash flows.

### Business Risks

Business risks are associated with a bank's business environment, including macroeconomic and policy concerns, legal and regulatory factors and the

overall infrastructure of the financial sector. Business risk also includes the risk of becoming insolvent as a result of having insufficient capital to continue operations. While IFIs are exposed to the regular business environment, solvency, and infrastructure risks, they are particularly exposed to one specific business risk—the rate-of-return risk.

### **Rate-of-return Risk**

The rate-of-return risk stems from the uncertainty in the returns earned by Islamic banks on their assets. This uncertainty can cause a divergence from the expectations investors have on the liabilities side. The larger the divergence, the bigger the risk. Another way of looking at this risk is that it is the risk generally associated with overall balance-sheet exposures where mismatches arise between assets and balances of the depositors. For example, an Islamic bank is expected to make five percent on its assets, which will be passed on to the investors/depositors. Meanwhile, if current market rates rise to six percent, which is higher than what the bank may make on its investment, the investment account holders/depositors may also expect to earn the same on their deposits.

The rate-of-return risk differs from interest rate risk in two ways. Firstly, since conventional commercial banks operate on interest-based fixed-income securities on the assets side, there is less uncertainty in the rate of return earned on their investments if investments are held till maturity. Since Islamic banks have a mix of mark-up based and equity-based investments, this uncertainty is higher. Secondly, the return on deposits in conventional banks is predetermined; in contrast, the returns on deposits in Islamic banks are expected but not pre-agreed. In addition, returns on some investments—those based on equity partnerships, for example—are not known accurately until the end of the investment period. If, during this period, the prevailing yield levels or expected rates of returns in the market change, then the investors may expect similar yields from the bank.

It therefore becomes the responsibility of Islamic banks to manage the expectations of their investment account holders/depositors, which makes the rate-of-return risk also a strategic risk issue as part of the business environment. Two sub-categories of rate-of-return risk have been identified, as follows:

***Displaced commercial risk:*** This was first identified by the AAOIFI as the risk that arises when an Islamic bank is under pressure to pay its investment depositors a rate of return higher than what should be payable under the “actual” terms of the investment contract. This may occur when the bank has underperformed during a period and was unable to generate adequate profits for distribution to the account holders.

To mitigate this risk, banks may decide to waive their portion of profits in order to dissuade depositors from withdrawing their funds and investing elsewhere. An extreme example was the action by the International Islamic Bank for Investment & Development in Egypt, which distributed all of its

profits to investment account holders while the shareholders received nothing from the mid to late 1980s (Warde 2000). In 1988, the bank distributed to its depositors an amount exceeding its profits, and the difference appeared in the bank's accounts as "loss carried forward." The practice of forgoing part or all of its shareholders' profits may adversely affect its own capital, which can lead to insolvency risk in extreme cases.

The experience gained from such self-imposed practices to mitigate the displaced risk has led to the development of two standard practices in the industry. The first practice is the maintenance of a Profit Equalization Reserve (PER), which the financial institution funds by setting aside a portion of the gross income before deducting its own share (as *mudarib*). The objective of the reserve is to maintain a cushion to ensure smooth future returns and to increase the owners' equity for bearing future shocks. Similar to the PER, an Investment Risk Reserve (IRR) is maintained out of the income of investment account holders/depositors after allocating the bank's share, in order to dampen the effects of the risk of future investment losses. It has been suggested that the basis for computing the amounts to be appropriated should be predefined and fully disclosed.

### **IFSB PRINCIPLES OF RATE OF RETURN RISK**

**Principle 6.1:** [Islamic Financial Institution] shall establish a comprehensive risk management and reporting process to assess the potential impacts of market factors affecting rates of return on assets in comparison with the expected rates of return for investment account holders (IAH).

**Principle 6.2:** [Islamic Financial Institution] shall have in place an appropriate framework for managing displaced commercial risk, where applicable.

While maintaining reserves in this way is becoming common practice, it has attracted objections as well. While the practice is in alignment with prudent risk management, it raises a governance issue that needs attention. Firstly, limited disclosure of such reserves makes investment account holders uneasy and they do not have the right to influence the use of such reserves and verify the exposure of overall investments. While those with long-term investment objectives may welcome this practice, those with a short-term view may feel that they are subsidizing the returns of the long-term investors. Some banks require investment account holders to waive their rights on these reserves.

IFIs should standardize the practice and the rights of their investment account holders to these reserves should be clearly stated and explained to

depositors. It has been suggested that making deductions from the profits belonging to investment account holders should apply only to long-term depositors, who are more likely to be exposed, and not to depositors who are not exposed to such risk.

**Withdrawal risk:** Withdrawal risk arises mainly from the competitive pressures an IFI faces from its Islamic or conventional counterparts. An Islamic bank could be exposed to the risk of withdrawals by its depositors as a result of offering a lower rate of return than its competitors. If an Islamic bank is run inefficiently and keeps producing lower returns, this will lead to withdrawals, which could eventually erode the franchise value of the bank.

### **Treasury Risks**

Treasury risks include those arising from cash management, equity management, short-term liquidity management, and assets-and-liabilities management (ALM). Generally, responsibility for the risk management function of a financial institution falls to the treasury and therefore any inability to manage risks properly can be a risk itself. Typical treasury risks that are critical for an IFI are liquidity, ALM, and hedging risks, as discussed below.

**Liquidity Risk** Liquidity is necessary for banks to compensate for any fluctuations (expected and unexpected) in the balance sheet and to provide funds for growth. It represents a bank's ability to accommodate the redemption of deposits and other liabilities and to cover the demand for funding in the loan and investment portfolio. A bank is said to have adequate liquidity potential when it can obtain needed funds (by increasing liabilities, or securitizing/selling assets) promptly and at a reasonable cost. The price of liquidity is a function of market conditions and the market's perception of the inherent riskiness of the borrowing institution.

Liquidity risk also results when the bank's ability to match the maturity of assets and liabilities is impaired. Such risk results from the mismatch between maturities on the two sides of the balance sheet, creating either a surplus of cash that must be invested or a shortage of cash that must be funded. Lack of liquidity adversely affects the bank's ability to manage portfolios in a diversified fashion and to enter or exit the market when needed.

Liquidity risk as it applies to Islamic banks can be of two types: lack of liquidity in the market, and lack of access to funding. In the first type, illiquid assets make it difficult for the financial institution to meet its liabilities and financial obligations. In the second, the institution is unable to raise funds at a reasonable cost, when needed.

Since an IFI will be acting as an asset manager and will not have access to funds through a debt security to meet its liquidity needs, it will be exposed

to liquidity risk if (i) it has not aligned its liabilities and assets on the same maturity ladder; or (ii) it has invested in market securities which suddenly face liquidity issues; or it had placed funds in customized over-the-counter assets (for example, special *mudarabah* and *musharakah* assets).

The current financial crisis has highlighted the significance of liquidity in the assets market. This further highlights the need for a robust secondary market and mechanisms to securitize the assets of financial intermediaries to facilitate liquidity in the markets.

The treasury management function becomes a challenging task affecting the performance of Islamic banks, since they are particularly vulnerable to liquidity risk, given their limited access to external funds to meet their obligations. For the following reasons, liquidity risk can be considered as one of the most critical risks faced by Islamic banks:

- The limited availability of *Shari'ah*-compatible money and intra-bank markets is the leading cause of the liquidity risk. Prohibition by *Shari'ah* law from borrowing on the basis of interest and the absence of an active interbank money market have restricted Islamic banks' options to efficiently manage their liquidity positions. Conventional banks have access to borrowing, from overnight to extended short-term maturity, through well-developed and efficient interbank markets. This access to short-term borrowing is vital for meeting short-term cash-flow needs.
- Shallow secondary markets are another source of the liquidity risk. The number of *Shari'ah*-compliant financial instruments that can be traded in the secondary market is limited. Therefore, there is a need for the further development of asset-backed tradable securities such as *sukuk*. Even where there are instruments currently available, the number of market participants is limited.
- Typical avenues of liquidity management available to conventional banks, namely the interbank market, secondary-market debt instruments, and discount windows from the lender of last resort (central bank), are all considered to be based on *riba* and therefore unacceptable.
- Certain characteristics of some Islamic instruments can also lead to liquidity risks. For example, cancellation risks in *murabahah*, or the non-permissibility of trading of contracts based on *murabahah* or *bay' al-salam*, pose liquidity problems.
- Islamic banks have a considerable amount of funds in current accounts which are demand deposits and can be withdrawn at any time. Repayment of principal amounts deposited by current-account holders is guaranteed by the bank without any rights to a share in the profits. Islamic banks may be investing only a small fraction of the current-account holders' funds and may be maintaining high levels of liquidity in the form of idle cash in the absence of illiquid short-term instruments.

**IFSB PRINCIPLES OF LIQUIDITY RISK**

**Principle 5.1:** [Islamic Financial Institution] shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their liquidity exposures in respect of each category of current accounts, unrestricted and restricted investment accounts.

**Principle 5.2:** [Islamic Financial Institution] shall undertake liquidity risk commensurate with their ability to have sufficient recourse to *Shari'ah*-compliant funds to mitigate such risk.

Malaysia has taken significant steps to promote Islamic banks and to provide solutions to reduce liquidity risk. The central bank, Bank Negara Malaysia, introduced the Islamic Interbank Money Market (IIMM) in early 1994. The activities of the IIMM included the purchase and sale of Islamic financial instruments among market participants (including the central bank), interbank investment activities through the *Mudarabah* Interbank Investment (MII) Scheme and a check-clearing and settlement system through an Islamic Interbank Check Clearing System (IICCS). The Islamic financial instruments that are currently being traded in the IIMM on the basis of *bay' al-dayn* are what are known as Green bankers acceptances, accepted Islamic bills, Islamic mortgage bonds and Islamic private-debt securities. In addition, financial institutions can sell Government Investment Issues (GIIs) to the central bank, as and when required, to meet their liquidity needs. GIIs are government securities issued on an Islamic basis, which financial institutions can also buy from the central bank, depending on the availability.

**ALM Risk** Assets-and-liabilities management (ALM) risk is a balance-sheet mismatch risk resulting from the difference in maturity terms and the conditions of a bank's portfolio on its assets and liabilities sides. ALM comprises strategic planning, implementation, and control processes that affect the volume, mix, maturity, profit-rate sensitivity, quality, and liquidity of a bank's assets and liabilities. The primary goal of ALM is to produce a high-quality, stable, large, and growing flow of net income. This goal is accomplished by achieving the optimum combination and level of assets, liabilities, and financial risk.

ALM risk arises from the difference in maturity terms and conditions of a bank's portfolio on its assets and liabilities sides. In theory, Islamic banks should not be exposed to the same asset-liability mismatch, and therefore to equity-duration risk, as their conventional counterparts. This comparative advantage is rooted in the pass-through nature of Islamic banks, which act



as agents for investors/depositors and pass all profits and losses through to them. In addition, the risk-sharing feature in which banks participate with their counterparties and investors/depositors plays a critical role. Direct market discipline, one of the three main pillars recently emphasized by the Basel Committee on Banking Supervision in enhancing the stability of the international financial market, is embedded in this risk-sharing principle.

Following the theoretical model, any negative shock to an Islamic bank's asset returns is absorbed by both shareholders and investors/depositors. While depositors in the conventional system have a fixed claim on the returns to the bank's assets (receiving a predetermined interest rate in addition to their guaranteed principal, irrespective of the bank's profitability on its assets side), holders of profit-sharing investment accounts in the Islamic system share in the bank's profits and losses alongside the shareholders and are exposed to the risk of losing all or part of their initial investment. The assets and liabilities are matched as a result of the pass-through structure.

The risks of a financial intermediary are better understood when the sources and applications of funds under management by the financial intermediary are viewed as sub-portfolios of distinct risk/return and maturity profiles. Table 13.3 provides an overview of the sources and application of funds for a hypothetical IFI. The composition and mix of different maturity buckets on the assets side depend on each financial institution, which may select a mix to match its needs to those of its depositors.

Although, as per theory, an IFI will not be exposed to ALM risk in the traditional sense, it will face other challenges. Rather than matching the assets and liabilities at the balance-sheet level, the challenge becomes one of offering a wide range of products on the liabilities side to different classes of depositors/investors to meet their specific investment objectives. In other words, the IFI will have to design funds or portfolios to meet the risk/return objectives of its investors; otherwise, the investors would simply prefer to become shareholders. Although the contractual agreement between

**TABLE 13.3** Sources and application of funds

Sources (liabilities and equity)	Application (assets)
Equity capital and shareholders' reserves	Short-term trade finance ( <i>murabahah, salam</i> )
Demand and safekeeping deposits ( <i>amanah</i> )	Regulatory cash-reserve requirement Medium-term investment ( <i>ijarah, istisna'</i> )
Investment accounts ( <i>mudarabah</i> ) "pass-through"	Long-term partnerships ( <i>musharakah</i> )
Special investment accounts ( <i>mudarabah, musharakah</i> )	Fee-based services ( <i>jo'alah, kifala</i> , and so forth)

Source: van Greuning and Iqbal (2008)

the IFI and the investors/depositors would be based on a risk-sharing and profit/loss-sharing basis, the IFI still has to design investment products for varying risk appetites and maturity ladders.

In that case, the ALM exposure becomes merely an operational matter of aligning products on the liabilities side to the portfolios on the assets side, and the challenge would be to ensure that the funds are not comingled across investor classes and maturity ladders. This requires ensuring transparency in the management of different portfolios.

In this respect, the IFI's role in the financial system would be similar to that of a conventional asset manager and the balance sheet would resemble a fund-of-funds, which would not be exposed to any ALM risk but would be subject to operational risks.

**Hedging Risk** Hedging risk is the risk of failure to mitigate and manage different types of risks. This increases the bank's overall risk exposure. In addition to non-availability of derivative products to hedge risks, illiquid, non-existent and shallow secondary markets are other sources of the increasing hedging risk of the Islamic banks.

### **Governance Risks**

The importance of governance and the risks associated with poor governance have recently attracted the attention of researchers and policymakers. Governance risk refers to the risk arising from a failure in governing the institution, negligence in conducting business and meeting contractual obligations, and from a weak internal and external institutional environment, including legal risk, whereby banks are unable to enforce their contracts.

### **Operational Risk**

A related type of governance risk is operational risk, defined as the risk of loss resulting from the inadequacy or failure of internal processes, as related to people and systems, or from external risks. Operational risk also includes the risk of failure of technology, systems and analytical models. It is argued that operational risks are likely to be significant in the case of Islamic banks because of their specific contractual features and the general legal environment. Specific aspects that could increase operational risks in Islamic banks include:

- Cancellation risks in the non-binding *murabahah* and *istisna'* contracts
- The failure of internal control systems to detect and manage potential problems in the operational processes and back-office functions, and technical risks of various sorts
- Difficulties in enforcing Islamic contracts in a broader legal environment
- The need to maintain and manage commodity inventories, often in illiquid markets

- The costs and risks in monitoring equity-type contracts and the associated legal risks.

People risk is another kind of operational risk and arises from incompetence or fraud that leads to potential losses. For instance, an internal-control problem cost the Dubai Islamic Bank US\$50 million in 1998 when a bank official did not comply with the bank's credit terms. This also resulted in a run on its deposits of US\$138 million, representing 7 percent of its total deposits, in just one day (Warde 2000).

Operational risk is considered high on the list of exposures of Islamic banks. A survey conducted by Khan and Ahmed (2001) shows that the managers of Islamic banks perceived operational risk as the most critical after mark-up risk. The survey found that operational risk is lower in fixed-income assets of *murabahah* and *ijarah* and one of the highest in the deferred-sale contracts of *salam* and *istisna'*. These rankings of the instruments indicate which contracts the banks find more complex and difficult to implement.

### **Fiduciary Risk**

Fiduciary risk is the risk that arises from an institution's failure to perform in accordance with explicit and implicit standards applicable to its fiduciary responsibilities. Fiduciary risk gives rise to the risk of having to face legal action in a situation where the bank breaches its fiduciary responsibility toward depositors and shareholders. As fiduciary agents, Islamic banks are expected to act in the best interests of investors/depositors and shareholders. If and when there is divergence between these expectations and its actions, the bank is exposed to fiduciary risk.

The following are some examples of fiduciary risk:

- In the case of a partnership-based investment in the form of *mudarabah* and *musharakah* on the assets side, the bank is expected to perform adequate screening and monitoring of projects and any negligence in this regard—deliberate or inadvertent—can lead to fiduciary risk. It becomes incumbent upon management to perform due diligence before committing the investors/depositors' funds.
- The mismanagement of funds of current-account holders, which are accepted on a trust (*amanah*) basis, can expose the bank to fiduciary risk as well. It is a common practice of Islamic banks to utilize such funds without any obligation to share the profits. However, in a case of heavy losses on the investments financed by these funds, the depositors can lose confidence in the bank and this can lead to their seeking legal redress.
- Mismanagement that leads to the incurring of unnecessary expenses, or allocating excessive expenses to investment account holders is a breach of the implicit contract to act in a transparent fashion.

Fiduciary risk can lead to dire consequences. First, it can damage a bank's reputation and create panic among depositors, who may decide to withdraw their funds. Secondly, it may result in legal action that can lead to a financial loss in the form of penalties or compensation payments. Thirdly, it can have a negative impact on the market price of shareholders' equity and on the bank's costs and access to liquidity. Where a bank is unable to meet the demands of its current and investment account holders, it may lead to insolvency.

### **Transparency Risk**

Transparency is defined as "the public disclosure of reliable and timely information that enables users of that information to make an accurate assessment of a bank's financial condition and performance, business activities, risk profile and risk-management practices." Accordingly, lack of transparency creates the risk of incurring losses from bad decisions based on incomplete or inaccurate information. Islamic banks are exposed to transparency risk by the practice of non-standard accounting and financial reporting of Islamic financial instruments, which are different from conventional instruments and therefore require different conventions of reporting to truly reflect the financial picture. Transparency also demands that all banks in the system use a uniform set of standards, which is not the current practice.

### **Shari'ah Risk**

*Shari'ah* risk is related to the structure and functioning of the *Shari'ah* boards at the institutional and systemic level. This risk is of two types: the first comes from non-standard practices in respect of different contracts in different jurisdictions; the second is the result of failure to comply with *Shari'ah* rules. For instance, while some *Shari'ah* scholars consider the terms of a *murabahah* or *istisna'* contract to be binding on the buyer, others argue that the buyer has the option to decline even after placing an order and paying the commitment fee. While each practice is acceptable to different schools of thought, the bank's risk is higher in non-binding cases and it may lead to potential litigation problems in unsettled transactions.

Banks are exposed to the risk of non-compliance with the *Shari'ah* rules and principles determined by the *Shari'ah* board or the relevant body in their particular jurisdiction. The nature of the relationship between the bank and the investors/depositors is not only that of an agent and principal, but it is also based on an implicit trust between the two that the agent will respect the desires of the principal to fully comply with the *Shari'ah*. This relationship distinguishes Islamic banking from conventional banking and is the sole justification for the existence of the Islamic banks. If the bank is unable to maintain this trust and its actions lead to non-compliance with the *Shari'ah*, it runs the risk of breaking the confidence of its investors/depositors. Breaching this trust can have dire consequences, including the withdrawal and insolvency risk. Therefore, the bank should give high priority to ensuring transparency

in compliance with the *Shari'ah* and take any necessary actions to avoid any non-compliance.

Some *Shari'ah* scholars have suggested that if a bank fails to act in accordance with the *Shari'ah* rules, the transaction should be considered null and void and any income derived from it should not be included in the profits to be distributed to the investors/depositors.

### **Reputation Risk**

Reputation risk or “headline risk” is the risk that the trust of the clients is damaged by irresponsible actions or behavior on the part of the bank. The implications of this are wide-ranging in that the irresponsible behavior of a single institution can taint the reputation of other Islamic banks. Negative publicity can have a significant impact on an institution’s market share, profitability and liquidity. The Islamic financial services industry is a relatively young industry and a single failed institution can give a bad name to all others that may not be engaged in any such irresponsible behavior. Close collaboration among financial institutions, the standardization of contracts and practices, self-examination, and the establishment of industry associations can help to mitigate reputation risk, to which all Islamic banks in a given market are exposed.

An IFI enters into a contract with its stakeholders that it will conduct its business according to the spirit of *Shari'ah* and is required to fulfill this obligation to the best of its abilities. In addition, the institution has made an implicit contract to ensure that no violation of *Shari'ah* principles occurs. Anytime it fails to meet these obligations or is guilty of breach of contract, it runs the risk that stakeholders will withdraw their business.

The IFI is subject to higher standards of preserving the property rights of its stakeholders and to ensure that it does not withhold anyone’s rights, willingly or unwillingly. To breach this sacred trust would be to risk its reputation.

### **Risks Associated with *Sukuk***

As the *sukuk* market expands, it is important that the risks associated with it are fully understood. On the surface, a *sukuk* appears to be like a debt-based fixed-income security. This being the case, the common practice is to apply to it the same risk management framework. However, a *sukuk* has distinctive features that can give rise to non-conventional risks, as outlined below.

Although similar in structure, *sukuk* are different from conventional asset-backed securities. By design, a *sukuk* is supposed to be a true asset-based securitization where the risk/return is passed on to the owners. However, the practice is different and it is often structured to minimize direct exposure to the underlying assets. The investors need to understand the structure and the exposures of each structure.

It is critical that investors know who owns the underlying or securitized assets in a particular *sukuk* because, depending on the answer, risks can change. For example, under some conditions, investors may not be able to sell the underlying assets independently or may not be fully protected from the borrower's insolvency. In other circumstances, investors may be exposed to the corporation's creditworthiness (a practice that is considered to be in conflict with the basic principles of risk sharing) or to that of the underlying assets or projects. The *sukuk* market has serious liquidity issues arising from a shortage of supply, which leads investors to buy and hold the contract, rather than trading it in the market. This results in a shallow secondary market where the transaction costs (measured by bid-ask spreads) are much higher. This exposes investors to liquidity risk and impairs their ability to manage their portfolios in an efficient and cost-effective manner.

Investors are also exposed to transparency risk because structuring *sukuk* transactions involves complex legal documentation which can lead to unconventional legal positions and can become a source of ambiguity and future disputes. The lack of clarity can lead to reputational risk for the parties, including the arrangers, issuers and regulators.

### **Risk Management Framework**

The complex nature of risks faced by Islamic banks requires a comprehensive risk management, risk reporting and risk control framework.

Efficient risk management is essential for reducing an organization's overall risk exposure. Adequate resources need to be devoted to identifying and measuring risks and developing appropriate techniques for managing them. The IFSB has formulated a set of principles for sound risk management that should be followed by Islamic banks to mitigate the various risks they are exposed to. There are several areas in which there is room for improvement. These are discussed below.

#### **IFSB PRINCIPLES OF RISK MANAGEMENT**

- [Islamic Financial Institution] shall have a sound process for executing all elements of risk management, including risk identification, measurement, mitigation, monitoring, reporting and control. This process requires the implementation of appropriate policies, limits, procedures and effective management information systems (MIS) for internal risk reporting and decision making that are commensurate with the scope, complexity and nature of the activities.

(Continued)

- [Islamic Financial Institution] shall ensure an adequate system of controls with appropriate checks and balances are in place. The controls shall (a) comply with the *Shari'ah* rules and principles; (b) comply with applicable regulatory and internal policies and procedures; and (c) take into account the integrity of risk management processes.
- [Islamic Financial Institution] shall ensure the quality and timeliness of risk reporting available to regulatory authorities. In addition to a formal standardized reporting system, [Islamic Financial Institution] shall be prepared to provide additional and voluntary information needed to identify emerging problems possibly giving rise to systemic risk issues. Where appropriate, the information contained in the report shall remain confidential and shall not be used for public disclosure.
- [Islamic Financial Institution] shall make appropriate and timely disclosure of information to Investment Account Holders (IAH) so that the investors are able to assess the potential risks and rewards of their investments and to protect their own interests in their decision-making process. Applicable international financial reporting and auditing standards shall be used for this purpose.

**Quantitative Methods of Risk Measurement** Risk assessment and measurement is an art as well as a science. The increased complexity of financial instruments calls for more sophisticated risk assessment tools. While work on identifying the sources of risk associated with Islamic banking has made good progress, risk measurement techniques and the models used to quantify risk need to be applied more widely.

Sundararajan (2004) has suggested several quantitative methods for measuring risk. For example, similar to the idea of value at risk (VaR), the risk to investors/depositors can be quantified by a measure of profit at risk (PaR) based on the historical profits and the volatility of returns. The PaR model assumes normal distribution and can be calculated as follows:

$$\text{PaR} = Z\alpha \times \sigma p \times \sqrt{T}$$

where  $Z\alpha$  = is the constant that gives the appropriate one-tailed confidence interval with a probability of  $1-\alpha$  for the standard normal distribution (e.g.,  $Z_{\dots,01} = 2.33$  for 99% confidence interval);  $T$  is the holding period or maturity of investment account as a fraction of a month; and  $\sigma p$  as the standard deviation of the monthly profit as a percentage of assets.

The PaR measure can have multiple uses. First, it can provide an indication of the level of volatility in the expected profits of investors/depositors. Secondly, it can determine the level of income-smoothing reserves—the Profit Equalization Reserves (PER) maintained by some IFIs to mitigate displaced

commercial risk. The correlation between the PER and the asset's return could, therefore, be an indicator of "displaced commercial risk." Thirdly, the PaR model can also be applied to individual business lines within the bank, such as the case of specific portfolios linked to restricted investment deposits to determine the level of risk. The application of quantitative models such as PaR can help management with their decision-making regarding the level of PER and can offer transparency to investors regarding the volatility of profits.

Trade financing and lease-based financial instruments on the assets side of IFIs resemble fixed-income asset-based securities and thus some of the standard risk measurement techniques such as duration, gap analysis, bucketing, DV01, and Value-at-Risk (VaR) can be computed to monitor the level of the risks. Baldwin (2002) provides a discussion on duration and VaR measures for Islamic instruments. The use of such monitoring tools becomes more important for IFIs given the lack of risk-mitigating derivative products and the low liquidity of the assets. Also, there could be issues in the use of parametric VaR for instruments based on *mudarabah* and *musharakah* contracts and therefore alternative measures should be designed.

On the credit risk side, the valuation of collateral needs special attention. Although the use of collateral is recognized as a legitimate risk mitigation tool, in practice, many supervisory authorities tend to underestimate the existence of collateral because the valuation and determination of fair market value is not an easy task, especially in the case of underdeveloped markets. Therefore, advanced models based on simulations and other analytical techniques should be developed to measure the extent of exposure arising from credit risk.

**Implementation Challenges** Implementation of the risk management framework requires close collaboration between the IFIs, regulators and supervisors. At the institutional level, it is the responsibility of management to establish internal systems that can identify, measure, monitor, and manage various risk exposures. Although the general principles of risk management are common to both conventional and Islamic financial institutions, IFIs face the following specific challenges:

- Establishing supporting institutions and systems such as a lender of last resort, a deposit insurance system, a liquidity management system, secondary markets, and a legal infrastructure favorable to Islamic instruments and for the efficient resolution of disputes.
- Achieving uniformity and harmonization in *Shari'ah* standards across markets and borders. The current practice of maintaining individual *Shari'ah* boards by individual institutions is inefficient and should be replaced by a centralized board within each jurisdiction.
- Developing risk management systems is costly and out of reach for many Islamic financial institutions. Efforts should be made to collaborate with other institutions to develop systems that are customized to the needs of IFIs and which address instrument-specific modeling needs.



- Effective risk management will assist IFIs to integrate with global financial markets. Efforts should be made to enhance transparency in financial reporting and to development accounting and reporting standards across markets.
- Risk management requires highly skilled human resources, which are currently in short supply. Efforts should be made to develop customized research and training programs to spread the knowledge and awareness of the significance of risk management. Such training programs should provide for the certification of successful participants.

The sub-prime financial crisis was also attributed to the failure of risk-management frameworks. Several institutions that had such a framework were surprised when the risk models failed to predict the problems and did not estimate the risks accurately. During the boom periods, financial institutions had become heavily reliant on risk and other quantitative models, but as the financial markets increased in complexity so did the risk models. For example, a well-known and frequently used standard measure for risk, VaR, came under fire after the crisis for its unrealistic assumptions and the way it was applied in the decision-making process. The main lesson of the financial crisis for the risk management profession was that the financial institutions need to develop a culture of mixing quantitative with qualitative or subjective analysis. The use of sophisticated risk measures is still not widespread in the majority of IFIs and they need to develop both proper risk models and an institutional culture that supplements risk measures with qualitative judgments based on experience and knowledge of the markets.

## CHAPTER 14

# Regulation of Islamic Financial Institutions

### INTRODUCTION

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Firms in the financial services industry, especially banks and insurance companies, are subject to various forms of regulation. As the industry has advanced, the regulation of it has also become more experienced, complex and dynamic. The nature of regulation of any industry can be understood by asking the questions: Why is regulation required? What needs to be regulated? How should this be done? The rationale for regulation (the “Why?”) is the same for IFIs and conventional financial institutions alike, but there are clear differences in the “What?” and “How?” questions.

Diverse views on the need for regulation in conventional finance range from positions of almost total opposition to any regulation, to the justification of broad, intrusive regulation. The arguments for the regulation of conventional financial services include the public good, mitigation of systemic risk, the protection of depositors, and the integrity of fiduciary contracts.

### The Public Good

One view of regulation is that it provides a public good that the market cannot supply on its own. The objective of prudential regulation is to mitigate risks taken by the stakeholders (for example, depositors) unable to undertake the necessary due diligence to enable them to assess these risks. Some stakeholders have sufficient investment savvy to develop these assessments on their own and would not, in principle, need in the same degree the support of public regulation, except for transparency and disclosure requirements necessary to conduct their due diligence. Consequently, from the public-good perspective, the design of prudential regulation would call for a clear sense of the type, quality and quantity of the public good to be delivered, as well as the nature of the risk and risk exposure or values at risk involved.

### **Mitigation of Systemic Risk**

Another rationale for regulation, linked to the notion of public good, is that it is a pre-emptive measure to avoid or mitigate any systemic risk that can lead to a contagious collapse of the financial system. Such mitigation can reduce the financial distress and social costs associated with the failures. Banks are particularly vulnerable to such collapses because of the nature of their business; that is, illiquid assets financed by liquid liabilities. Therefore, the objective of prudential regulation is the mitigation of the risk of disruption of the normal business performed by the financial system in payments or the provision of liquidity. Such systemic risks could be the outcome of a spillover from distress in one institution unable to honor its commitments, undermining confidence in the system. It could also be the result of a failure in the payments system itself—either of its material infrastructure or of the mechanisms and instruments to exchange liquidity.

### **Protection of Public Resources**

Another view of financial regulation is that the existence of an explicit or implicit safety net, notably in the form of deposit insurance, creates a contingent government liability. The existence of such a commitment of public resources entails both the right and the duty of the public authority to regulate activities that may endanger these resources. This view is not unrelated to the public-good view, as the existence of deposit insurance is itself a public service. The existence of any safety net or deposit insurance also creates a moral hazard, as it reduces the incentive for depositors to impose market discipline on banks with regard to their risk taking. Regulation is one of the means to check such moral hazard.

### **Integrity of Fiduciary Contracts**

Another perspective on regulation is provided by a focus on the fiduciary nature of the business of finance. The role of regulation is seen here as the provision of sufficient checks and balances to mitigate the risk of the intermediary failing the trust of its stakeholders. These are generally seen as the depositors, but also include small shareholders, which underlines the importance of sound corporate governance.

In the light of this rationale, Chapra and Khan (2000) suggest four reasons for the regulation of IFIs:

- i) *Systemic considerations*, particularly the need to maintain an orderly payments system and ensure the development of the economy.

Maintaining orderly payments is clearly in the nature of a public good which needs to be protected. Whether IFIs operate according to core principles or follow prevailing practices, regulation to mitigate the risks of disruption in payments can be justified.

In contrast, the promotion of economic development may be beyond the role that should be assigned to financial regulation. Expansion and growth is promoted by increased trust in the financial system that regulation can provide. However, its design to explicitly promote development may distort its objectives of ensuring soundness and stability, and pose difficult challenges for regulators in having to choose between promoting economic development and ensuring the stability of the financial system.

- (ii) *Protecting the interests of demand depositors.* The protection of demand depositors is envisaged in the two-windows model of an Islamic financial intermediary, which asks for the maintenance of 100-percent reserves against demand deposits.
- (iii) *Ensuring compliance with the Shari'ah.* The relationship between civil and religious law varies across national jurisdictions. Where there is a strong separation of the two, it is difficult to justify assigning to public authorities the role of ensuring that financial intermediation activities comply with the *Shari'ah*. This is considered a private religious matter that does not call for public intervention. The issue of truth in disclosure and in advertising, however, remains and gives stakeholders legal redress. This is not, however, a matter of financial regulation, but one of broad institutional infrastructure for business. In jurisdictions where the distinction between civil and religious law is less pronounced, one can well see a public policy choice for assigning to a public regulator the role of ensuring that banking activity complies with the *Shari'ah*.
- (iv) *Supporting the integration of IFIs in the international financial system.* Integration would develop from the participation of IFIs in the financing of international trade and international payments. Counterparts would want to be satisfied with the ability and commitment of IFIs to fulfill the contracts they enter into. In this respect, national and international regulation can be grounded in the public good and needs to ensure orderly participation in international payments and the integrity of fiduciary contracts.

## **DISTINCTIVE FEATURES OF REGULATING IFIs**

Having considered the “Why?” of financial regulation, we now turn to the “What?” and the “How?” It has been often argued that the case for introducing regulation to protect the value of deposits of IFIs fully abiding by risk-sharing principles is less compelling than for conventional finance. IFIs are different from conventional banks in several respects, which makes their regulation somewhat different. The areas of difference are as follows.

### **The Nature of Intermediation**

The financial intermediation undertaken by IFIs is based on the principal-agent model and the contractual relationship is based on the profit/loss-sharing

principle, which is different to the intermediation relationship between depositors and conventional banks. Given the partnership-based relationship, the two-tier *mudarabah* model of Islamic banking does not require banks to have reserves. It is argued that in the presence of symmetrical risk as well as profit/loss sharing, introducing a guarantee on the downside would run counter to the essence and the core objective of the system. Investment depositors should, however, expect to be informed on the features of the contract they enter into and have recourse to law if it is breached. Therefore, the focus of regulation will shift from protection of investment account holders to ensuring the integrity of the fiduciary contracts.

### **Depositors vs. Investors**

Depositors in the conventional banking system create a debt claim on the financial institution, whereas the depositors in the Islamic banking system are investors and therefore do not create such a claim; rather, they act like pseudo-equity holders. Because of the pass-through nature of intermediation, where all profits and losses are passed through to them, investors theoretically do not have a claim on the capital of the bank except in cases of misconduct or negligence. This pass-through feature has a major impact on the capital requirements of Islamic banks. Requiring a certain minimum level of capital is the cornerstone of the regulation of conventional banks.

### **Systemic Risk**

Islamic banks are not immune from bank runs when depositors/investors lose confidence in the bank and withdraw funds in panic. Large volumes of panic withdrawals by investment account holders could result in financial distress. Archer (2004) argues that unlike conventional banks, which maintain liquid assets on their liabilities, the assets of Islamic banks are illiquid, which makes such risk primarily a liquidity risk. In the event of a liquidity crisis, a conventional investment firm will generally be able to wind down its business in an orderly manner by meeting its obligations through prompt disposal of marketable securities at the market price. In contrast, an Islamic bank's asset portfolio is dominated by less-liquid trade-financed or rental-generating assets, which exacerbate the problem of illiquidity and therefore the systemic risk.

### **IFIs AS UNIVERSAL BANKS**

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As mentioned in earlier chapters, financial intermediation performed by IFIs combines commercial and investment banking activities similar to a universal bank in the conventional system. This combination of banking with securities (underwriting) operations demands that a different regulatory framework, including capital-adequacy requirements, be applied to

banking and securities operations. Differences in commercial and investment banking activities have led to the adoption of a “banking book/trading book” approach in the EU Capital Adequacy Directive of 1993. The securities activities grouped as “trading book” are subject to a capital-adequacy regime that is separate from the banking business as defined by the “banking book” (Archer 2004). One marked difference in the case of IFIs is that the trading operations are not confined to securities business only, but also include positions in commodities and other non-financial assets (for example, by means of *salam* and *istisna'* contracts). Given the universal-banking nature of Islamic financial intermediation, it is important that well-defined rules and standards are designed to clearly demarcate the boundaries of banking and trading books, with respective allocations of capital, depending upon the nature of business.

Regulators have traditionally governed their jurisdictions through direct rules, mostly on capital, assets, and income allocations. At the same time, regulatory changes often lag behind financial developments and may consequently either constrain the ability of financial institutions to flexibly manage their portfolios, or provide them with opportunities to take unchecked risks, implicitly comforted by the existence of the safety net. In adapting to these developments, the industry is now moving toward letting the regulated institutions assess and manage their risks within a framework agreed on with the regulator. In this context, there is a call for the introduction of mechanisms to let the market impose the necessary discipline on the financial intermediaries. The essence of market discipline is to induce market investors to penalize excessive risk taking by raising the cost of funding and limiting its availability. This can happen directly, with depositors demanding higher returns or withdrawing their deposits. It can also happen indirectly if there is an asset traded in the market whose price reflects the investors' assessments of the risks being taken by the issuing institution.

In light of the discussion on risks and the rationale for regulation, it is clear that capital, transparency, and licensing requirements are primary candidates for regulation. The method of regulation will depend, to varying degrees, on a combination of direct “command and control” rules, market discipline (direct and/or indirect), or organization-specific home-developed risk assessments. The type and method of regulation chosen depends on the adopted rationale for regulation, on the extent to which IFIs follow core principles, and on the assessment of their practices.

For IFIs that follow strict risk sharing principles, there would be minimal regulation required. There would be less emphasis on capital requirements, and more on transparency and disclosure, management screening, and licensing of business lines; that is, regulation equivalent to conventional banking. There would be greater reliance on direct market discipline and less on “command and control” regulation.

The two-tier *mudarabah* or two-windows frameworks use, for the most part, profit/loss-sharing (PLS) accounts on both sides of the balance sheet. They would provide trade finance or facilitation, as well as payments

services. They would take demand deposits as part of these services. The PLS intermediation has direct market discipline embedded in it and, hence, should not require significant capital. Some minimal capital may be needed to protect the reputation of the institution, which is its legitimacy as a partner for all its stakeholders. But one could argue that sufficient transparency and disclosure should allow markets to judge this legitimacy and induce the institution of its own volition to maintain the needed level of capital. The case for a capital requirement to protect orderly payments and demand deposits would be stronger. It is not likely to lead to the same level of capital requirement, but suggests the need to consider the appropriateness of bundling the intermediation and payments services in the same balance sheet. Consequently, the regulation of an IFI, compliant with risk sharing principles, would need to put a heavy emphasis on transparency and disclosure as well as licensing requirements, but de-emphasize capital requirements.

In existing IFIs, prevailing intermediation practices point to the need for equivalent emphasis on capital requirements, supervision and licensing, but more emphasis on transparency and disclosure than for conventional banks. Competitive pressure is encouraging the established IFIs to provide sufficient safety and return to depositors in unrestricted investment accounts. They consequently face the risk of “displacing” shareholders in their returns and capital to accommodate these depositors. As a result, they face an intermediation risk similar to that faced by conventional banks and should therefore be subject to similar capital and supervision requirements.

To summarize, keeping in view the rationale for regulation, it is reasonable to propose minimal regulation for IFIs operating fully in accordance with the core principle of risk sharing. However, as prevailing practices of IFIs are not fully compliant with profit/loss-sharing principles, the situation presents risks akin to those in conventional banking. Therefore, a similar regulatory framework can be justified. Such specific regulation for IFIs should be supplemental to the existing regulatory framework and not a whole new separate framework. This is the view notably taken by both the AAOIFI and the IFSB.

### **CAPITAL ADEQUACY REQUIREMENT FOR IFIs**

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Capital plays an important role in any business but is critically important for financial institutions such as banks. The role of capital is vital for a banking institution because capital is one of the key determinants and indicators of the safety and soundness of a bank, since an adequate capital base serves as a safety net against losses and absorbs possible losses. A well-capitalized bank can boost the confidence of the depositors and creditors. It is also the ultimate determinant of a bank's lending and investment capacity.

For these reasons, it is argued that the capital of a bank should have three important characteristics: (i) it must be permanent; (ii) it must not impose mandatory fixed charges against earnings; and (iii) it must allow for legal subordination to the rights of depositors and other creditors. The

nature of a financial intermediary such as a bank is such that its capital-to-liabilities ratio is lower than other types of businesses. This low ratio is a reflection of the nature of the intermediation business and acceptance of large liabilities in the form of deposits. To encourage prudent management of the risks associated with this unique balance sheet structure, the regulatory authorities require that the banks maintain a certain level of capital, which is considered adequate to meet the risks of the assets. The idea behind such a requirement is that a bank's balance sheet should not be expanded beyond the level determined by the ratio of the level of the capital and the risks of the assets, so that the level of capital determines the maximum level of assets.

In the 1980s, the Basel Committee on Banking Supervision (BCBS), under the auspices of the Bank for International Settlements (BIS), developed a framework to determine capital-adequacy standards for banks with the objectives of promoting soundness and stability in the international banking system. This initiative resulted in the Basel Capital Accord of 1988 (commonly referred to as "Basel I"), which laid the framework for a "regulatory capital" and defined the guidelines to measure the risk exposures of different asset classes. The Basel Accord introduced the concept of assigning risk weights to different asset classes based on the riskiness of the asset and defined the minimum levels of capital and reserves that a bank should maintain in order to meet the risk-weighted exposures.

The determination of capital adequacy is a two-step process. The first step involves the measurement of risk exposures of the assets based on the risk weights. For example, an investment in a government security is assigned a lower risk weight than the lendings to a corporation or private business, which carries a significant credit risk. In the second step, the regulatory capital available to support the risk is measured. This is divided into Tier 1 and Tier 2 capital. The ratio of regulatory capital to the amount of risk-weighted assets is the capital adequacy ratio (CAR). The aim of Basel I was to indicate a minimum recommended level of regulatory capital, with a CAR of eight percent.

The Capital Accord standard has been accepted and adopted by more than 100 countries. Although the initial standard was mainly focused on credit risk, a refined standard in 2004 ("Basel II")<sup>1</sup> included provisions for market and operational risks, but the desired CAR level was unchanged. The notion of a minimum capital requirement should not be confused with the optimal economic capital. The minimum capital is a guideline and requirement by regulatory authorities, but well-capitalized banks tend to carry more than the minimum level and the regulator of a particular country may decide to increase this level based on the level of risk in the system.

With the growth of Islamic banks, the issues of regulation and capital requirements are being raised and addressed. The BCBS framework for capital adequacy provided the impetus for dealing with similar issues for the Islamic banks. Although the need for a minimum capital ratio was recognized, it was argued that the nature of intermediation by Islamic banks is different from that of conventional banks and therefore the same capital requirements



may not apply. Two main features of Islamic banks were highlighted: the nature of intermediation and the risk weights of the assets they held.

### **CAR and the Nature of Intermediation**

Unlike depositors of conventional banks, the contractual agreement between the Islamic bank and the investment account holders (IAHs) is based on the concept of sharing profit and loss, which makes IAHs unique in that they are neither depositors nor equity holders. Although IAHs are not part of the bank's capital, they are expected to absorb all losses on the investments made through their funds, unless there is an element of negligence or misconduct on the part of the bank. The nature of intermediation and liabilities has serious implications for the determination of adequate capital for Islamic banks, as follows:

- Deposits taken on the basis of profit/loss-sharing agreements should not be subject to any capital requirements other than to cover liability for negligence and misconduct, and winding-down expenses.
- Investments funded by current accounts carry commercial banking risks and should be subject to adequate risk weights and capital allocation accordingly.
- The existence of restricted investment accounts on the liabilities side constitutes a collection of heterogeneous investment funds resembling a fund-of-funds and therefore such financial institutions should be subject to the same capital requirements as are applicable to a fund manager.
- The presence of displaced commercial risk and the practice of income smoothing have indirect implications for the Islamic bank's capital adequacy, which a regulator may take into account in determining the CAR.
- Islamic banks acting as an intermediary (*mudarib*) can face a moral-hazard issue. Since, as *mudarib*, the bank is not liable for losses but shares the profits with IAHs, it may have an incentive to maximize the investments funded by IAHs and by attracting more IAHs than it has the capacity to handle. This in turn can lead to risky investment decisions where the IAHs have a lower tolerance for risk that they are prepared to accept. Such a misalignment of incentives may lead to an increased displaced commercial risk, which necessitates higher capital requirements.

### **Determination of Risk Weights**

Determining which risk weights to assign to different asset classes depends on the contractual relationship between the bank and the borrower. For conventional banks, a majority of assets are debt-based, whereas for Islamic banks the assets range from trade financing to equity partnerships; this fact changes the nature of risks. In some Islamic instruments there are additional risks that are not present in conventional lending instruments. Therefore,

the calculation of risk weights for the assets of Islamic banks differs from that for conventional banks because:

- Assets based on trade are not truly financial assets and carry risks other than credit and market risks.
- There are non-financial assets such as real estate, commodities, and *ijarah*- and *istisna*'-based contracts that have special risk characteristics.
- Islamic banks carry partnership and profit/loss-sharing assets, which have a higher risk profile.
- Islamic banks do not have well-defined risk mitigation and hedging instruments such as derivatives to hedge some of the risks on the assets side, which raises the overall risk level of assets.

In partnership-based contracts such as *mudarabah* and *musharakah*, the bank is exposed to both credit and market risks which need to be analyzed within the credit and market risk methodology of the Basel Accords. When such partnership-based assets are acquired in the form of tangible assets—commodities—and are held for trading, the only exposure is to the market risk because the credit risk is minimized by direct ownership of the assets. However, there is significant risk in the form of the risk of capital impairment when direct investment takes place in partnership-based contracts and the investments are intended to be held to maturity. Treatment of this risk within the Basel framework is not straightforward and therefore requires special attention.

### **CAR for IFIs: IFSB Methodology**

In the early 1990s, the AAOIFI drafted a basic standard on capital adequacy of Islamic financial institutions. In December 2005, the IFSB working group on capital adequacy issued the first draft of its capital-adequacy standards for institutions (other than insurance institutions) that offered only Islamic financial services. This document includes a comprehensive discussion of the nature of risks and the appropriate risk weights to be used for different assets. The standard deals with the minimum capital adequacy requirements for both credit and market risks for seven of the *Shari'ah*-compliant financing and investment instruments: *murabahah* and *mudarabah*; *salam*; *istisna*'; *ijarah*; *musharakah* and diminishing *musharakah*; *mudarabah*; and *sukuk*.

#### **IFSB PRINCIPLES FOR MINIMUM CAPITAL ADEQUACY REQUIREMENTS**

- The minimum capital adequacy requirements for IFIs shall be a CAR of not lower than 8 percent for total capital. Tier 2 capital is limited to 100 percent of Tier 1 capital.

(Continued)

- In calculating the CAR, the regulatory capital as the numerator shall be calculated in relation to the total risk-weighted assets (RWA) as the denominator. The total of RWA is determined by multiplying the capital requirements for market risk and operational risk by 12.5 (which is the reciprocal of the minimum CAR of 8 percent) to convert into risk-weighted equivalent assets, and adding the resulting figure to the sum of RWA computed for credit risk.
- The *Shari'ah* rules and principles whereby IAHs provide funds to the IFI on the basis of profit-sharing and loss-bearing *mudarabah* contracts, rather than debt-based deposits—that is, lending money to the IFI—would mean that the IAHs would share in the profits of a successful operation, but could also lose all or part of their investments. The liability of the IAHs is exclusively limited to the capital provided and the potential loss of the IIFS is restricted solely to the value or opportunity cost of its work.
- However, if negligence, mismanagement or fraud can be proven, the IFI will be financially liable for the capital of the IAHs. Therefore, credit and market risks of the investment made by the IAHs shall normally be borne by themselves, while the operational risk is borne solely by the IFI.

The IFSB standard requires that an IFI maintain a minimum capital of 8 percent of the total risk weighted assets. The assets financed by IAHs are excluded, considering that the IAHs directly share in profits and losses of those assets and the loss to the bank (as *mudarib*) is limited to the time and resources spent on the investments, except in cases of negligence and misconduct. Therefore, it is argued that the risks on the assets financed on the basis of profit/loss-sharing agreement by investment account holders do not represent risks for the IFI shareholders' capital and thus should not entail a regulatory capital requirement for the IFIs. This implies that assets funded by either an investment account holder—unrestricted or restricted—are to be excluded from the calculation of the capital ratio.

The IFSB standard (see Table 14.1) is defined in two forms: standard and discretionary. In the standard formula, capital is divided by risk-weighted assets excluding the assets financed by IAHs, based on the rationale given earlier. The size of the RWA is determined for the credit risk first and then adjusted to accommodate for the market and operational risks. To determine this adjustment, the capital requirements for market risk and operational risk are multiplied by 12.5, which is the reciprocal ratio ( $1/0.08$ ) of the minimum CAR of 8 percent. For example, if an asset has a capital charge of 10 for market risk, the RWA will be increased by  $10 \times 12.5 = 125$ . Similarly, if the capital requirement for operational risk is 5, then the weight would be  $5 \times 12.5 = 62.5$ .

Determining Risk Weights: An Example

Risk weights are assigned depending on the nature of the asset and the kind of collateral. For example, if an Islamic bank provides *murabahah* financing to a client, and there is no pledged collateral, a risk weight of 100 percent is applied to the value of the asset. On the other hand, if the client pledges collateral with a market value of X, then the asset value is reduced by 75 percent of X before applying the risk weight of 100 percent to the asset. An asset valued at \$500,000 will have a risk weight of \$500,000 if there is no collateral and of \$425,000 if collateral worth \$100,000 is pledged, as follows:

$$\$425,000 = (\$500,000 - \$100,000 \times 75\%) \times 100\%.$$

For a *musharakah* (equity) investment, when there is no third-party guarantee, the credit risk weight of 400 percent is assigned. However, this weight is reduced considerably when there is a third-party bank guarantee and a risk weight of only 20 percent (for AAA-rated bank guarantees) is assigned.<sup>2</sup>

In the Supervisory Discretion formula (see Table 14.2), the formula is modified to make appropriate adjustments to accommodate the existence of

TABLE 14.1 IFSB CAR standard formula

Eligible Capital		
(Total Risk-weighted Assets) PLUS (Operational Risk Capital Requirement)	MINUS	Total Risk-weighted Assets Funded by PSIA

Notes:

- Risk weighting includes weights for market and credit risk.
- PSIA = Profit Sharing Investment Accounts.
- PSIA balances include Profit Equalization Reserves (PER) and Investment Risk Reserve (IRR).

TABLE 14.2 IFSB CAR Supervisory Discretion formula

Eligible Capital	
(Total Risk-weighted Assets) PLUS (Operational Risk Capital Requirement)	$(1 - \alpha) \times$ Total Risk-weighted MINUS Assets Funded by PSIA MINUS $\alpha \times$ Risk-weighted Assets Funded by PER and IRR

Notes:

- Risk weighting includes weights for market and credit risk.
- PSIA balances include PER and IRR.
- $\alpha$  refers to the proportion of assets funded by PSIAs which is to be determined by the supervisory authorities. The value of  $\alpha$  would not normally be expected to exceed 30 percent.

reserves maintained by IFIs to minimize commercial displaced, withdrawal and systemic risks. In markets where IFIs are maintaining PER and IIR, the supervisory authorities are given discretion to adjust the denominator of the CAR formula according to their judgment of the systemic risk and prevailing practices.

This percentage is applied to assets financed by both unrestricted and restricted IAHs. Further adjustment is made for PER and IRR reserves in such a manner that a certain fraction of the risk-weighted assets funded by the reserves is deducted from the denominator. The rationale given for this adjustment is that these reserves have the effect of reducing the displaced commercial risk.

As Basel II takes into account the capital requirements for operational risk, the IFSB's exposure draft also deals with the issue in detail. Difficulties in quantifying the exposures from operational risk make determining how much capital should be allocated for such risks complex. The IFSB recommends that this may be based on either the Basic Indicator Approach or the Standardized Approach.<sup>3</sup> It is further recommended that, given the different structure of their lines of business, at the present stage IFIs may use the Basic Indicator Approach. An example of how CAR may be calculated is shown in Table 14.3.

**TABLE 14.3** IFI CAR computation: An example

<b>Liabilities:</b>	
Demand Deposits	\$200M
Unrestricted Investment Account Deposits	\$500M
Restricted Investment Account Deposits	\$250M
PER and IRR	\$50M
Shareholders' Capital	\$20M
<b>Assets:</b>	
Trade Financing ( <i>Murabahah</i> )	\$550M
<i>Salam/Ijarah/Istisna'</i>	\$250M
<i>Mudarabah</i> and <i>Musharakah</i> Investments	\$220M
Total Risk-weighted Assets for credit risk	\$250M
Risk-adjusted Assets Financed by Investment Account Holders	\$100M
Risk-adjusted Assets Financed by PER and IRR	\$10M
Supervisory Authority's discretion ( $\alpha$ )	30%
Adjustment for Market and Operational Risk ( $12.5 \times \$5M$ )	\$62.5M

**CAR According to Standard Formula:**

$$\frac{\$20}{(\$250M + 62.5M) - (\$100M + \$10M)} = 9.88\%$$

**CAR According to Supervisory Discretion Formula:**

$$\frac{\$20}{(\$250M + 62.5M) - (0.7 \times \$100M - 0.3 \times \$10M)} = 8.35\%$$

## **BANK SUPERVISION AND MARKET DISCIPLINE**

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Basel I was an early attempt to define the framework for ensuring financial stability, but it was a simplistic approach that focused mainly on capital requirements. Increased market volatility and rapid development and the introduction of innovative products into the financial markets, together with a series of financial crises spreading from one continent to another, soon exposed the weakness of Basel I. The financial crisis in East Asian countries in 1997 and that in Eastern Europe in 1998 were evidence of the increased complexity of risks faced by international banks and highlighted the need for improved transparency, governance and supervision of financial institutions.

In light of these factors, in June 2004 the BCBS issued a Revised Framework (Basel II) which, in addition to capital adequacy (Pillar I), deals with the principles of the enhanced supervisory review process (Pillar II) and effective use of market discipline (Pillar III). While the new framework aims to provide a comprehensive approach to measuring banking risks, its fundamental objectives remain the same as those of the 1988 Accord: to promote the safety and soundness of the banking system and to enhance the competitive equality of banks. All three pillars are mutually reinforcing and no one pillar should be viewed as being more important than another.

The message of Basel II is that a robust financial system infrastructure and adequate macro prudential surveillance are the prerequisites for effective supervision and risk management. Several recent studies by the World Bank and the IMF have highlighted the significance of having the appropriate balance of prudential supervision and market discipline in Islamic finance, and the related implications for the organization and financial stability of the industry. These studies stress the importance of disclosure and market discipline in Islamic finance, because the different nature of the risks of IFIs and their limited capacity for risk mitigation expose them more than the conventional financial institutions. This exposure is further enhanced by the inadequacies of its financial infrastructure, manifest in such things as a low level of transparency, the absence of derivative instruments and markets, and a weak insolvency and creditor-rights regime. Weak disclosure and low market discipline also call for active supervision.

While understanding the risks and the allocation of capital under Pillar I is a critical step, the core elements of supervision (Pillar II) and market discipline (Pillar III) are equally or more important. A well-designed capital requirement standard cannot be made effective in the absence of strong and prudent supervision. Therefore, the strengthening of the existing supervisory framework to achieve full compliance with the core principles of Basel is highly desirable for IFIs, particularly in relation to the disclosure requirements on risk exposures and risk management processes.

The disclosure practices of IFIs are highly varied. Although the AAOIFI Financial Accounting Standards provide a sound basis for further developing prudential disclosures, it has been suggested that this should have two key purposes: (i) to develop consumer-friendly disclosures to inform investment account holders on the inherent overall risks that they face, and the related policies about investment risk exposures and mitigation; and (ii) to develop market-oriented disclosures to inform the public at large, particularly other professional counterparties, including regulators (who will require more details, not publicly disclosed) on capital, risk exposures and capital adequacy, along the lines of Pillar III of Basel II. The true risks borne by the investment account holders can be made transparent by enhancing the reporting and disclosure requirements. For example, disclosure of the definition, levels and variations of *mudarabah* profits and profit equalization reserves will help investors in determining the level of their exposure while also providing valuable insights to supervisors.

The following issues pertaining to the implementation of Basel II are worthy of further discussion:

- **Risk Reporting:** The significance of risk reporting should not be underestimated and it is necessary that IFIs work together and with the supervisory authorities to implement a comprehensive risk reporting framework. The IFBS has recently emphasized the need for just such a process, including appropriate board and senior management supervision to identify, measure, monitor, report and control relevant categories of risks and to ensure the adequacy of reporting to the supervisory authority. Supervisory authorities themselves need to allocate resources to ensure timely implementation of the proposed framework.
- **Information Infrastructure:** There is a need to establish an information gathering infrastructure to provide reliable information about the creditworthiness of borrowers, the fair value of collateral and independent valuation of assets. This requires a systematic effort of data collection and analysis, the establishment of credit registries that can track the credit history of potential borrowers, and well-functioning rating agencies. There is now increasing recognition that credit registries with appropriate modifications in data content could facilitate systematic credit risk measurement.
- **Liquidity Enhancement:** IFIs have limited choices for maintaining liquidity, especially in times of stress. The availability of liquidity is critical for risk management and it is essential, therefore, that IFIs allocate resources to introduce liquidity-enhancing financial instruments through securitization and the development of capital markets.
- **Fragmentation and Concentration:** IFIs are often fragmented, highly concentrated, and are small compared to average conventional banks. As a result, IFIs do not have enough opportunities to gain from the benefits of diversification. Supervisors need to monitor IFIs that have significant exposure to a particular industry or deposit base. Supervisory authorities should also encourage IFIs to seek diversification. Through geographical diversification of the deposit base, an IFI can reduce its

exposure to displacement or withdrawal risks. Diversification on the asset side can reduce the variance in the returns that accrue to the claimholders of the financial intermediary. The geographical spread of products can further help an IFI mitigate its credit risk by selecting borrowers of the best credit quality and avoiding those with weak credit quality. Further diversification benefits can come from economies of scope by extending the line of products and services.

- **Investment in Risk Management Infrastructure:** Establishing risk-assessment and measurement systems often becomes an expensive proposition, as it requires sophisticated models, software and technologies, and skilled human resources who can understand the nature of the risks and prepare models accordingly. Measurement and control of the operational risk are still evolving. Given the small average size of Islamic financial institutions, establishing such a framework at the organization level may not be possible. IFIs and supervisory authorities should work together to find a reasonable solution to this problem.

## REGULATION OF IFIs: LOOKING FORWARD

The legal and regulatory practice governing IFIs varies across countries (as illustrated in Table 14.4). Indonesia, Iran, Lebanon, Malaysia, Pakistan, Sudan, Turkey, the UAE, and Yemen have enacted Islamic banking laws. However, these laws may not always take full account of the unique characteristics of Islamic banking. For example, the Malaysian Islamic Banking Act (1993) refers to banking as a “lending business” and investment accounts are considered to be liabilities. In Iran, IFIs accept customer investments on the basis of the *wikala* agency contract,<sup>4</sup> not the *mudarabah* contract as is the case in other countries. In Saudi Arabia and Egypt, no laws have been enacted to regulate IFIs, which operate under the same laws governing conventional banks.

**TABLE 14.4** Diversity in legal, regulatory and supervisory arrangements

Country	Banking System	AAOIFI Standards	Islamic Banking Law	Existence of <i>Shari'ah</i> Boards	Supervision
Iran	Islamic	No	Yes	No	No
Jordan	Dual	IAS	Yes	Yes	Consolidated
Kuwait	Dual	IAS	Considered	Yes	Consolidated
Sudan	Islamic	Yes	Yes	Yes	–
Yemen	Dual	No	Yes	Yes	No
Malaysia	Dual	IAS	Yes	Yes	Consolidated

Source: Compiled from Zaher and Hassan (2001), Chapra and Khan (2000), El-Hawary, Grais and Iqbal (2004)



Effective regulation requires readable, reliable signals of the risks that a financial institution faces as a consequence of its own behavior or from events external to it, as well as risks that may affect the financial system through contagion or infrastructure failure. It also requires an ability to process these readable signals and to introduce appropriate corrective actions as needed. In this respect, the role of the broader institutional infrastructure is critical. Of particular importance is the clarity and enforceability of property rights, the quality of the contract law and the feasibility of quick action in cases of breach, the efficiency of judicial recourse and other dispute-resolution mechanisms. The majority of IFIs, however, operate in jurisdictions where these matters leave much to be desired, to the detriment of their performance.

The quality and transparency of accounting and auditing practices play a crucial role. The measurement and comparison of risk exposure should underlie regulation. The efforts towards establishing accounting and auditing standards for IFIs have made a significant contribution in this respect. However, disclosures of accounting results may not be an adequate instrument for risk-assessment purposes because, as a structure, accounting is directed toward value, not risk allocation. This situation gives additional importance to other services, such as the collection and dissemination of financially relevant information and credit rating. In addition, it would call for renewed efforts at enhancing the relevance of accounting and auditing for risk assessment. El-Hawary, Grais and Iqbal (2004) suggest that under the circumstances, regulators dealing with IFIs may want to consider a two-pronged strategy: managing current practices, and a transition toward stable and efficient intermediation. In managing current practices, regulators need to promote the stability of existing IFIs that conduct financial intermediation, reflecting the market pressures they face, their stakeholders' demands and their institutional environment. A long-term perspective for the industry calls for the development of a consensus on a vision on its nature, the role it would play in the development of the communities it serves, and how it would enact that role. A significant intellectual effort, geared towards providing practical ways of achieving consistency between the demands of the market place and the underlying principles, needs to be made. This effort needs to include debates that remain substantive, consultative, and evidence-based. In particular, it is important to be clear on the type of Islamic financial intermediation being considered, with special attention given to the core principles and how practice can develop consistent with them.

The combination of the services offered by IFIs and the prevailing practices they follow compound the difficulties of designing a regulatory framework to govern them. The problem of co-mingled funds from different classes of deposit holders particularly needs to be addressed. IFIs are often criticized for not maintaining proper firewalls between the funds of different investor classes and equity shareholders. This creates difficulties in both regulation and supervision. One approach for better regulation could be to encourage IFIs to structure their operations in clearly defined and separated segments catering to different classes of depositors, depending on their respective investment objectives. For example, one class of depositors

may be looking for custodial services only, while others may need to place funds for performing day-to-day transactions and therefore do not exhibit much risk appetite. Similarly, there may be a class of depositors that is less risk-averse and would like the IFI to deploy its savings for a longer term.

A visionary design consistent with the founding principles of Islamic finance could see an IFI structured as a group of fairly independent entities, each designed to optimize the functional demands of its clients. This view is presented by El-Hawary, Grais and Iqbal (2004), who argue that institutions offering Islamic financial services can be viewed as three distinct segments (see Table 14.5), which can then be regulated individually for greater stability and transparency.

Segment A is designed to handle funds for depositors who are highly risk-averse and require a high level of liquidity; who would use the funds for daily transactions; or would prefer to keep savings in safe assets where their capital (principal) is preserved. This segment would invest funds in asset-based securities with fixed-income characteristics and the IFI would intermediate by screening and monitoring such opportunities and making sure that credit and operational risks are contained. The concept is similar to narrow banking and would require a similar approach in its regulation.

Segment B is designed to cater to depositors with the next level of risk appetite who are willing to take some risk in the expectation of a higher return, with capital preservation and liquidity less high on their agenda. The IFI would deploy these funds in medium- to long-term instruments, such as *ijarah* or *istisna'*, or may prefer to invest on a *mudarabah* basis directly with the entrepreneur or through *mudarabah* certificates. If there is a well-developed secondary market for *mudarabah*-based funding, then the form of intermediation taken by the IFI will be very similar to mutual funds where the IFI will manage and invest the depositors' money in different *mudarabah* funds. Since the contractual agreement with the depositors would be similar to the fiduciary responsibility of a mutual fund in a conventional system, the same regulatory principles would apply.

**TABLE 14.5** A segmented view of an IFI

Assets	Liabilities
Asset-based/Trade Financing Minimal Risk	Segment (A) Depositors (Risk-averse Investors)
<i>ijarah</i> , <i>istisna'</i> , <i>mudarabah</i> Low-Medium Risk	Segment (B) Depositors (Low Risk Takers)
Partnership/Profit and Loss Sharing <i>musharakah</i> , <i>mudarabah</i> Venture Capital Private Equity Medium-High Risk	Segment (C) Depositors (Investors with Risk Appetite)

Source: El-Hawary, Grais and Iqbal (2004)

Segment C is designed for investors who are willing to take additional risk and are prepared to participate in riskier investments, like private equity or venture capital. IFIs could deploy these funds on the basis of *musharakah* or *mudarabah* instruments. With the former, the IFI also gets rights to participate in the governance of the enterprise, which raises another issue for the regulators. The IFI's relationship with *musharakah* enterprises would be of a long-term nature, with active involvement in governance, as opposed to a short-term, transactional relationship.

To summarize, an IFI structured to provide financial intermediation through clearly segmented windows, or even separate institutions, would make the task of the regulators easier. Each entity could then be subject to a regulating principle most suited to its nature. Such a separation could promote greater transparency of the risks faced by depositors, shareholders and regulators. The outlined framework would also bring to bear the market discipline through the risk sharing feature of Islamic financial intermediation, and contribute to the stability of the system. An Islamic financial industry incorporating such segmentation would likely require lighter and more focused regulation.

## **POST-CRISIS REGULATORY ENVIRONMENT AND IMPACT ON IFIs**

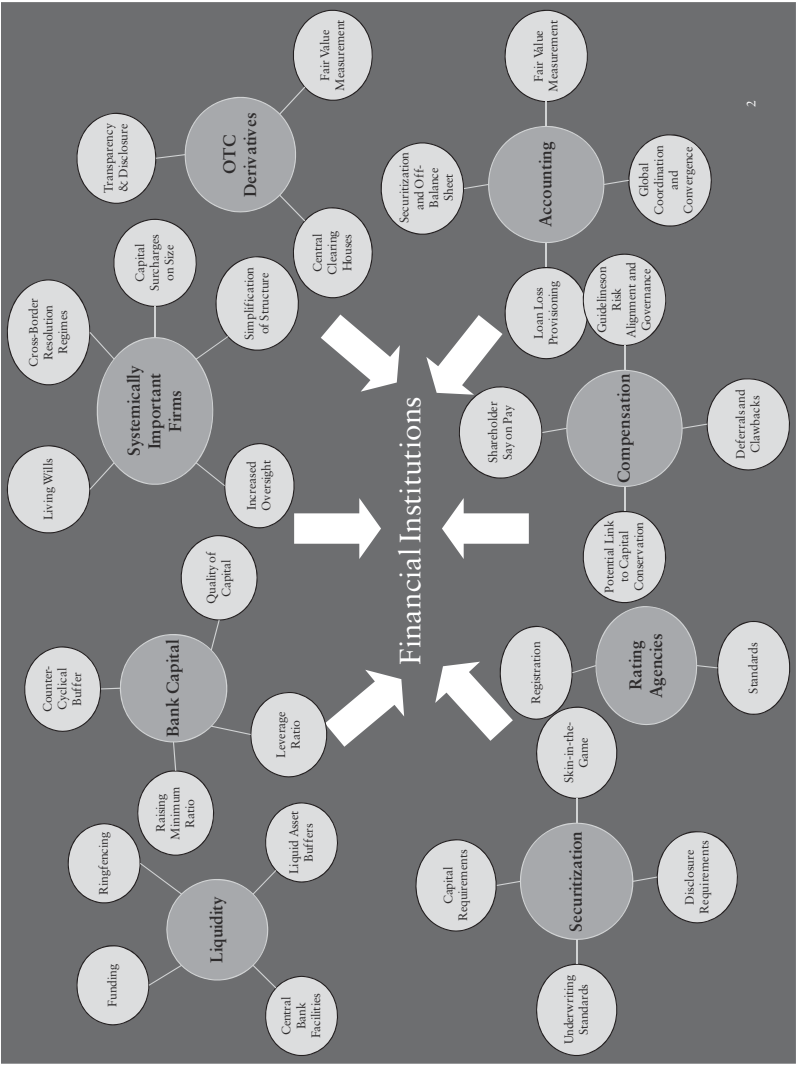
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There is no doubt that the lessons learnt from the crisis will shape the changes in the regulatory and supervisory framework and practices. The debate on which direction policymakers need to take has already heated up in several international fora, including the Financial Stability Forum (FSF), the IMF, national authorities, and standard-setting bodies who are collaborating to address the deficiencies and enhancements. Working groups at the FSF and G-20 are reviewing a wide spectrum of related issues, including complex and difficult legal and institutional hurdles to improving cross-border cooperation in regulation and the resolution of troubled institutions.<sup>5</sup>

Figure 14.1 is a very good depiction of how financial institutions are being surrounded by different pressure points which came to the surface during the crisis. This gives us an idea of the nature of the issues under consideration for shaping a new financial landscape. The environment within which today's financial institutions are operating is changing and the key drivers for the change include defining capital and its adequacy, liquidity, securitization, rating agencies, compensation, OTC derivatives, and systemically important entities. In this section, we will discuss select key drivers and how each will affect the Islamic financial services industry.

### **Capital Requirements**

The first realization is that the increased complexity in the financial system and growing innovation among financial institutions, without a clear



**FIGURE 14.1** Key drivers of regulatory change for financial institutions  
Source: Portilla (2009)

segregation between commercial and investment-banking activities, cannot be sustained within current capital requirements. Keeping this in mind, Basel III (which came into effect in September 2010) recommends that the financial institutions substantially raise the quality and quantity of capital, with a much greater focus on common equity to absorb losses. Enhanced capital buffers can help protect the banking sector against credit bubbles that can be drawn down during times of stress. Key features of Basel III's new capital requirements include (i) an increase in the minimum levels of Tier 1 capital; (ii) a change in the rules in regard to composition/definition of Tier 1 capital composed of retained earnings and common stock); (iii) a requirement for countercyclical shock-absorbers/buffers (that vary with the economic cycle); (iv) a requirement for a leverage ratio, limiting asset size (both on and off balance sheet); and (v) additional capital charges considered systematically relevant to firms.

Proposed changes in the capital requirements are a step in the right direction. The IFSB has already announced a review of existing capital-adequacy requirements in light of the proposed Basel III requirements. Determining capital requirements for Islamic financial institutions is not straightforward. There are two main issues. First, technically, Islamic financial intermediation is supposed to be on pass-through mode where all profits and losses on the assets side are passed to the liabilities side (to investors/depositors) and therefore the need for capital is minimal. In this mode of intermediation, as with mutual funds, the purpose of capital is to cover negligence and operational risk. However, the reality is that capital requirements have been set for Islamic financial institutions along similar lines to those for conventional banks to maintain the confidence of investors. Following the same tradition, it is expected that the capital requirements will also modified to comply with Basel III, although not strictly necessary. An increased capital requirement can also have an impact on the efficiency and return on equity for Islamic financial institutions.

The second issue concerns the exposure of Islamic financial institutions to real assets that are subject to price volatility as well as to liquidity risk. Several Islamic banks, particularly in the Middle East, have considerable exposure to the real estate sector. Depending on how the assets are valued—book value or market value—the financial health of Islamic banks can deteriorate as result of price volatility. In addition, requirements to adjust capital to economic cycles and the activities of Islamic banks to the real sector will also come into play. Policymakers and authorities can develop sophisticated capital requirements to combat pro-cyclical pressures only after they understand the nature of the risk/return rewards of assets for Islamic financial institutions, which are definitely different from those of their conventional counterparts. Since Basel III will change the capital charge for securitization risks, IFIs dealing with the *sukuk* market can also expect changes. Finally, as discussed below, additional requirements for liquidity in Basel III will put an additional burden on Islamic banks to maintain adequate capital and the levels of minimum capital are expected to increase.

## Liquidity

The current financial crisis has been called the “perfect liquidity surprise.” Liquidity problems associated with the crisis have forced regulators to get tough on this issue. Basel III incorporates the introduction of minimum liquidity standards and the monitoring of the liquidity coverage ratio (LCR) of financial institutions. The LCR is designed to ensure that the firm has enough liquid assets to cover a short-term crisis based on a predetermined set of cash inflows and outflows established by the BCBS. Such liquidity issues have serious implications for IFIs for several reasons. First, Islamic financial institutions do not have access to short-term liquidity through markets. One of the biggest impediments for IFIs is to develop liquid markets where securities can be traded efficiently at minimal transaction cost. Second, given the heavy concentration of trade or commodity finance, the assets of Islamic banks are illiquid; that is *murabahab*-based assets cannot be traded in the secondary market. Third, whereas conventional banks have access to liquidity provided by a lender of last resort, Islamic banks cannot benefit from such a facility as the lending is interest-based. This means that although an Islamic bank may be in good financial health, it could still face additional capital requirements because of low liquidity which could hamper its growth or efficiency.

## Quality of Information

For markets, policymakers and financial authorities, and multilaterals (IMF and World Bank) appropriate coverage and quality of information is becoming increasingly critical for their capacity to assess risks and vulnerabilities. Regulators are looking for better information on a range of activities such as off-balance-sheet risks (involving better consolidated supervision), and the risks of financial inter-linkages. The new regulatory and supervisory environment will be information-focused and financial institutions will be required to enhance the collection and disclosure of information as required by the regulators.<sup>6</sup>

This means that the financial institutions will have to improve, enhance, and upgrade the overall flow and quality of information in their institutions. They will need to be very focused on satisfying the reporting and disclosure requirements for the regulators and supervisors. They should expect to address this issue across all business lines and functional areas, from front to back office. For some institutions, it will require an upgrade of their risk-reporting systems or the development of new risk measures.

The general level of transparency and disclosure in the Islamic financial services industry is low. The impact of the new quality-of-information requirements could come from two directions. At the institutional level, the demand for the flow and quality of information within the institution to be enhanced could entail the automation of manual monitoring processes, the upgrading of information systems, and improving the transparency of data

and information for reporting purposes. This could be a challenge, considering that the majority of IFIs are small and do not have surplus funds to invest in the information infrastructure.

Quality of information is also relevant to investors and the regulators but in several countries where Islamic banks operate, general quality of information is considered low. Table 14.6 compares the information-disclosure index in MENA and G-7 countries. Table 14.7 shows the depth of credit information in the region. This index measures the rules and practices affecting the coverage, scope and accessibility of credit information available through either a public credit registry or a private credit bureau. The index shows relatively low levels compared to the developed economies of the G-7. National authorities and regulators need to take concrete steps to enhance information at a systemic level so that all participants in the system can benefit from it. Enhancing the flow and quality of information can be considered as a key driver to which the Islamic financial industry needs to pay attention.

### Risk Management Practices

As mentioned earlier, a failure of risk management practices was observed during the financial crisis and, as a result, they have come under close scrutiny,

**TABLE 14.6** Extent-of-disclosure index

	2005	2006	2007	2008	2009	2010
Average MENA	5.86	5.86	5.94	6.13	6.44	6.56
Average GCC	6.5	6.5	6.5	6.83	6.83	6.83
Average Non-GCC	5.6	5.6	5.6	5.7	6.2	6.4
Average G7	7.71	7.71	7.71	7.71	7.71	7.71

Source: DoingBusiness, World Bank

**TABLE 14.7** Depth-of-credit information index (0–6)

	2005	2006	2007	2008	2009	2010
Average MENA	1.93	2.21	2.69	3.13	3.5	3.69
Average GCC	3	3	3.33	3.83	3.83	3.83
Average Non-GCC	1.5	1.9	2.3	2.7	3.3	3.6
Average G7	5.71	5.57	5.57	5.57	5.57	5.57

Source: DoingBusiness, World Bank

with a review of the risk framework expected. It is expected that policymakers and regulators will be taking a very close look at how banks arrive at their measures of exposure, how they risk-weight their assets, and how they engage in risk mitigation activities. Requirements from the regulators on risk measures and enhanced quality of information will demand that financial institutions are vigilant to such requirements for new products and to comply with the regulatory requirements.

The risk framework in Islamic financial institutions is gradually evolving but is still in its early stages. The emphasis is currently on managing credit risk and the awareness of market and operational risk is not adequate. Some of the financial houses cannot afford extensive enterprise-wide risk management systems, which further exposes them to operational risk from their reliance on manual processes. Some technology vendors are taking their conventional products and offering them, with some modifications, to Islamic banks. However, it is critical that a proper risk framework for Islamic products and financial institutions is developed so that meaningful risk measures such as value-at-risk are developed and proper back-testing and stress-testing of exposures are undertaken to satisfy current and future requirements.

### **Supervisory Framework**

In the standard-setting area, the focus of policy work is on the market-risk rules, systemically important banks, the reliance on external ratings and large exposures. Basel III is the core regulatory response to the financial crisis but, with the regulatory changes, the next critical task is to promote more collaborative supervision at the global level. It is expected that, in addition to the further development of supervisory standards, authorities will be paying more attention to improving supervisory practices and cross-border bank resolution practices. A working group of the Financial Stability Board (FSB) has identified areas of the Core Principles for Effective Banking Supervision that could be expanded or clarified to address topics related to the supervision of systemically important financial institutions. One key challenge for bank supervision would be to assess risks associated with innovations and how such exposure is monitored.

The main challenge for both supervisors and the Islamic financial industry will be to develop and enhance the supervisory framework. In the MENA region for example, where there is large concentration of Islamic financial institutions, supervisory standards, legal institutions governing the resolution of large cross-border financial firms and insolvency issues are under-developed for both conventional and Islamic financial institutions. Unless these impediments are removed, the financial system will be prone to instability. The current practice is to treat Islamic and conventional banks in a similar way when it comes to supervision but this practice is not optimal. Islamic institutions have different contractual agreements and, without understanding the underlying contracts, supervision can overlook areas



of potential problems. Although, standards for exposure, governance, and supervision have been issued by the IFSB, these standards have yet to be adopted formally by regulators and national authorities. National supervisory authorities may be very familiar with the supervision framework and methodology of conventional financial institutions, but they need to pay attention to revising supervisory standards and manuals for Islamic institutions in addition to getting serious about implementing IFSB standards. Another dimension of complexity in supervision is introduced by the existence of Islamic windows from conventional banks and the need to maintain a proper firewall to segregate Islamic assets from conventional assets.

As Basel III incorporates macroprudential measures to help address systemic risk and the interconnectedness of financial systems, regulators and supervisors need to enhance supervision of Islamic institutions by forcing these institutions to improve their internal risk systems, their compliance with reporting requirements, the transparency of their disclosures, and the quality of information they put out. Without focusing on these issues, the authorities will not have a meaningful understanding of the risks such institutions pose to the system.

## ENDNOTES

1. See Basel Committee On Banking Supervision (BCBS) (2003), Consultative Document-Overview of the New Basel Capital Accord, April, Bank for International Settlements, Basel, Switzerland.
2. For detailed methodology of how to determine risk weights for different assets, consult IFSB standard on capital adequacy at [www.ifsb.org](http://www.ifsb.org).
3. Under the Basic Indicator Approach, a fixed percentage, namely 15 percent, of the annual average gross income, averaged over the previous three years, is set aside. Under the Standardized Approach, this percentage varies according to the line of business, from 12 percent for retail banking, asset management and retail brokerage to 15 percent for commercial banking and agency services, to 18 percent for corporate finance, trading and sales, and payment and settlement.
4. The *wikala* contract operates on the basis of the agent receiving a fixed fee, not a share of profits as in the *mudarabah*.
5. IMF (2009).
6. Ibid.

## CHAPTER 15

# Corporate Governance

**T**he issue of corporate governance and the search for an optimal governance structure has received considerable attention in the economic literature and in public-policy debates. This increased attention can be attributed to several factors such as:

- The growth of institutional investors—pension funds, insurance companies, mutual funds and highly leveraged institutions—and the role they play in the financial sector, especially in the major industrial economies
- Widely articulated concerns and criticism that the current monitoring and control of publicly held corporations, particularly in the UK and the US, is seriously defective, leading to sub-optimal economic and social development
- A shift away from the traditional “shareholder value-centered” view of corporate governance, towards a structure extended to a wide circle of stakeholders
- The impact of the increased globalization of financial markets, deregulation and the liberalization of the activities of institutional investors.

Although each of these factors provides compelling reasons to examine corporate governance structures, the current financial crisis has unearthed new governance issues, some of which were either ignored, not taken seriously, or were never even discussed earlier. Lapses in corporate governance were cited as one of the reasons why managers and policymakers failed to avoid the financial crisis, which caught everyone by surprise.

The concept of corporate governance is diverse and, over a period of time, the definition of the term has oscillated between two extremes—from a narrow concept of a mechanism for safeguarding investors’ interests, to a broad concept advocating the protection of all internal and external stakeholders’ rights. This wide spectrum of the concept stems from two divergent views: (i) how the entity of a “firm” should be perceived in an economic system, and (ii) the form of the incentive system to protect the rights and preserve the obligations of the economic agents in the environment in which the firm operates. Whether one views the firm as a bundle of assets and

liabilities, a legal entity, an economic or social organization, a nexus of contracts, or as a combination of these elements, will influence the way in which the evolution of the concept of corporate governance is analyzed.

Financial institutions have certain features that necessitate that greater attention be paid to their corporate governance for several reasons. First: As financial intermediation has become increasingly complex, simple governance structures are no longer effective. Financial innovations have introduced complexity and remoteness in governance structure. The resultant multiple layers of intermediaries and legal entities create ambiguity and confusion in implementing effective governance. Second: Financial firms supply and arrange funding for non-financial firms, which may place them in an advantageous position to exert control over the governance of their clients. This is particularly problematic when the financial system is dominated by intermediaries rather than the markets. Third: Financial firms are subject to significant information asymmetries which make it difficult to assess their management performance. Finally, corporate governance has the potential for free-rider problems. Limitations on takeovers, the concentration of ownership, prudential supervision, and investor protection may weaken product-market discipline and lead to the weakening of incentives for the private sector to undertake other governance functions.<sup>1</sup>

### **AN ISLAMIC PERSPECTIVE: STAKEHOLDER-ORIENTED GOVERNANCE**

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As explained in Chapter 2, the Islamic economic system is a rules-based incentive system with the ultimate goal of maintaining a just and harmonious social order. Rules impose restrictions on what the members may do without upsetting the social order on whose existence all members count in making their individual choices and actions. Therefore, attachment to and observance of the established rules guides the members of a society in their actions. The rules themselves are composed of those which deal with the individual's body and his state of consciousness, those which govern his relationships with others, and those which constitute the code of conduct necessary for the community as a whole. Rules serve to prevent conflict, reconcile the different purposes of many individuals and facilitate cooperation among them. If as a result of growth, a division of labor, or increasing complexities of markets, either the obligations attached to contracts or property rights are shirked or the rights of the society and the cohesion of the community are undermined, the legitimate authority is justified in intervening to take corrective measures.<sup>2</sup> Compliance with the rules promotes social integration and unity and preserves the intended social order.

The basic agency problem suggests a possible definition of corporate governance as that which constitutes an efficient monitoring structure solving the problems of both adverse selection and moral hazard. A corporate governance structure focused on the investor–manager contract and relationship

is often referred to as the “shareholder model.” It can be characterized as a model where (i) shareholders ought to have control, (ii) managers have a fiduciary duty to serve shareholders’ interests alone, and (iii) the objective of the firm ought to be the maximization of the shareholders’ wealth.

This traditional definition of corporate governance, propounded by economists and legal scholars, is based on the agency relationship between the investor and the manager and is concerned with the protection of shareholders’ or investors’ interests only.

The neo-institutional economists rely on the traditional agency theory to define the firm as a “nexus of contracts” and consider agents and transactions—institutionally, socially, legally, and culturally—as contingent (incomplete) constructs. They argue that the firm’s claimants go beyond shareholders and bondholders to include others with whom the firm has any explicit and/or implicit contractual interaction. In this nexus-of-contracts view, each corporate constituency, including employees, customers, suppliers and investors, provides some asset in return for some gain. Contracts are the result of bargaining by these constituencies over the terms of their compensation, as well as the institutional arrangements that protect this compensation from post-contractual expropriation.<sup>3</sup> According to this view, there is nothing unique to corporate governance; it is simply a more complex version of the standard contractual governance.<sup>4</sup> All stakeholders are regarded as contractors with the firm, with their rights determined through bargaining.

Stakeholder theorists reject the three main propositions of the shareholder system and argue that all stakeholders have a right to participate in corporate decisions that affect them, managers have a fiduciary duty to serve the interests of all stakeholders groups, and the objective of the firm is the promotion of all interests and not just those of shareholders. This view is commonly referred to as the “stakeholder model” of corporate governance, where “stakeholders” include customers, suppliers, providers of complementary services and products, distributors, and employees. Therefore, this theory holds that corporations ought to be managed for the benefit of all who have some stake in the firm.<sup>5</sup>

The stakeholder model is largely normative and is still evolving; it is yet to find a sound theoretical foundation in conventional economic literature. In this respect, the distinction between explicit (or formal) and implicit (or relational or self-enforcing) contracts and claims is the key to understanding the basis of the stakeholder model. When it is difficult to write complete state-contingent contracts, people often rely on “unwritten codes of conduct”—that is, on implicit contracts—which implies that in addition to the obligations on explicit contracts, obligations arising out of implicit contracts have to be incorporated into the “nexus of contracts” theory with convincing arguments. This can only be articulated by expanding the scope of analysis to encompass ethics, morals and the social order. Hart (2001) forcefully argues that many economic transactions are sustained by self-enforcing (“implicit”) contracts or norms of behavior, such as honesty or trust; concepts which so far have proved difficult to formalize in economic theory.

The second issue is how to draw a line of distinction between a stakeholder and a non-stakeholder. The existence of a stakeholder entity and its rights is easy to recognize, but questions still remain as to who really qualifies as an actual stakeholder. The third issue deals with the stakeholders' right to influence management decision-making or to participate in the governance of the firm. Questions arise as to why stakeholders should be given such a right and why managers should have a fiduciary duty to protect the rights of non-investor or non-owner stakeholders if such stakeholders have protected their rights, through bargaining, within the terms of the contracts. While there appears to be a consensus on identifying the rights of non-owner stakeholders and an implicit agreement to protect these rights, there is still a debate on why such stakeholders should participate in the control and management processes of a firm. So far, discussions of the stakeholder model have not been able to articulate a convincing argument on either theoretical, moral, or legal grounds to recognize an active role for the stakeholders in the management and control of a firm.

In considering the Islamic view of the role of stakeholders, it is noted that two fundamental concepts of the Islamic economic system pertaining to property rights and contracts govern the economic and social behavior of individuals, society and state. These two principles also dictate the objective function of the economic agents, including legal entities such as firms. A firm in the Islamic economic system can be viewed as a nexus of contracts whose objective is to minimize transaction costs with a view to maximizing profits and returns to investors, subject to the condition that these objectives do not violate the property rights of any party, whether it interacts with the firm directly or indirectly. In pursuit of these goals, the firm honors its obligations on explicit and implicit contracts without impinging on the social order. This definition incorporates the stakeholders' role in its view of the firm and supports recognition and protection of their rights.

### **Property Rights and Governance**

The design of the governance system in Islam can be best understood in light of the principles governing the rights of the individual, society, and state; the laws governing property ownership; and the framework of contracts. Islam's recognition and protection of rights is not limited to human beings only, but encompasses all forms of life as well as the environment. Each element of creation has been endowed with certain rights and each is obligated to respect and honor the rights of others. These rights are bundled with the responsibilities for which humans are held accountable.<sup>6</sup> The *Shari'ah* offers a comprehensive framework to identify, recognize, respect and protect the rights of every individual, community, society and the state. Islamic scholars and jurists have defined and codified detailed principles identifying these rights.<sup>7</sup>

The term "right" (*haq*) denotes something that can be justly claimed, or the interests and claims that people may have been granted by the *Shari'ah*. The majority of *Shari'ah* scholars and jurists hold that similar to a physical

property, rights are also property (*al mal*) because, like physical property, which has beneficial uses and can be possessed, rights also have beneficial uses and can be possessed.<sup>8</sup> Rules defining property rights in Islam deal with the rights of ownership, acquisition, usage and disposal of the property. Any violation of these rules is considered a transgression and leads to disruption in the social order.

As we saw in earlier chapters, the notion of ownership in Islam is two-tiered: (i) real and absolute, and belongs to Allah (*swt*) alone; and (ii) delegated to man and restricted through time-bound possession.<sup>9</sup> Ownership rights in Islam originate from the concept of stewardship (*khilafah*): as the *Qur'an* and *sunnah* make clear, Allah (*swt*) is the sole owner of property and that man is merely trustee and custodian.<sup>10</sup> This relationship implies that man has the right to use and manage his private property in a manner similar to that of a custodian and trustee. Property is not an end itself, but a means for man to discharge effectively his responsibilities as vicegerent.

The second axiom of property rights in Islam is that this right of possession is a collective right and individuals can only earn a priority in the use of these resources.<sup>11</sup> While a part of these resources is reserved for the exclusive possession of the collectivity, the remaining part is allowed to become the possession of an individual without the collectivity losing its initial right of possession to these resources. However, when individuals apply their creative labor to these resources, they get or acquire a right of priority in the use and enjoyment of the resulting product, but without the prior rights of others being nullified. This proposition becomes a legislative basis for requiring preservation of society's well-being and interests.

Social interest and the collective dimension of human life demand that individual freedom is kept within certain limits and a balance is created in such a way that the individual, the society, and the state each has a claim on property rights in respect of the roles assigned to them. The property rights of these three agents should not conflict with one another, nor should the exercise of those rights by any one of these agents jeopardize the exercise of rights by the others. Ibn Taimiyah (1263–1328) was one of the earliest scholars to recognize and advocate the rights of the society and the state along with private ownership.<sup>12</sup> If, as a result of the growth of the society, division of labor, or increasing complexities of markets, the obligation to share is shirked or the rights of the society and the cohesion of the community are undermined, or a harmonious social order is at stake, intervention by the legitimate authority to take corrective measures is justified.

The second axiom of property rights implies that while the individual's possession of these resources and his share in the outcome is allowed, sanctioned and protected by the *Shari'ah*, it is so only as long as it does not come into conflict with society's interests and well-being. Hence, private initiative and choice are recognized, but such recognition is not allowed to subvert the principle of sharing or to lead to a violation of the rights of the society and the state. However, once individuals have discharged their duties to society and state in conformity with the rules of the *Shari'ah*, their rights to their

possessions is held inviolate and no-one has a right to force appropriation (or expropriation) of that person's property to anyone else.<sup>13</sup> Ibn Taimiyah viewed property as a right to utilize an object but a right of varying kinds and degrees. Sometimes the right is an extended one so that the proprietor can sell or give away the object, lend it or make a gift of it, bequeath it or use it for productive purposes; but sometimes the right is incomplete, and therefore the proprietor's rights are limited or restricted.<sup>14</sup> Rules concerning the acquisition, possession, usage and disposal of property should be looked at as regulations rather than restrictions. The basic conditions for maintaining lawful rights to property are that the property should not have been acquired by unlawful means; the acquisition and its continuity should not result in any damage or harm to others; and the acquisition should neither invalidate any valid claim nor establish a non-valid one. Islam does not impose any cap on the amount of property that can be owned, or on the amount of wealth an individual can accumulate, as long as the individual conforms to the obligations set by the *Shari'ah*.

Individuals can obtain rights to property through their own creative labor and/or through the transfer—via exchange, contract, grants or inheritance—of rights from another individual who has gained title to the property or asset through their own labor. Property acquired through non-permissible and unjustifiable means such as gambling, bribery, theft, forgery, coercion, or illegal trading does not qualify as *al-mal* as defined by the *Shari'ah* and is therefore forbidden. Consequently, any property that is considered counterproductive or non-beneficial loses its legitimacy and its associated rights. Hoarding with the intention of creating artificial scarcity and profiteering are considered unacceptable means of building wealth and property. Similarly, property acquired through breach of trust, adulteration, non-compliance with weights and measures, or unethical means does not satisfy the definition of property and therefore its ownership is not considered legitimate.

Concomitant with property rights, the *Shari'ah* imposes responsibilities, among which are obligations not to waste, destroy, squander, or use the property for purposes not permitted by the *Shari'ah*.<sup>15</sup> To do so is to transgress the limits set on an individual's rights and an encroachment on the rights of others. While the right of use and enjoyment of property is affirmed by the *Shari'ah*, the exclusive and absolute right of disposal of property is rejected.<sup>16</sup> The prohibition of waste and squandering (*israf* and *tabdhir*) in all areas applies to property as well. An individual may not make an alteration in his property that may harm even his neighbor. If the property owner proves unable to use the property properly (within the boundaries defined by the *Shari'ah*), he forfeits his ownership rights and the legitimate authority is fully justified in withdrawing the rights of usage of that property.<sup>17</sup> This position is in conformity with both the Islamic conception of justice (*al-adl* and *al-ihsan*) and the rights and responsibilities of the individual and the community.

Islam's concept of property rights differs in many respects from those of conventional economic systems. At one extreme, proponents of the

market-based system argue in favor of individual private-property rights as fundamental rights; while at the other extreme, a small minority believes that private property is fundamentally immoral.

In contrast, Islam promotes a balance among the rights of individuals, society and the state. This concept sharply contrasts with the self-centered utility-maximizer economic agent idealized in neoclassical economics in an unbounded, insatiable, quest for acquisition and accumulation. Before the full market society came to prevail in the West, a great deal of the property rights in land and other assets was a right to use and enjoy the asset but not a right to dispose of it. However, it was thought that it was impossible to reconcile this particular right with a full market economy. Hence, of the two earlier kinds of property rights—the right to exclude others and the right not to be excluded by others—the second was all but abandoned and the conception of property rights was narrowed to cover only the right to exclude others. In Islam, however, this right is preserved without in any way diminishing the role of the market as a resource-allocating and an impulse-transmitting mechanism. Islam does not endorse the conventional notion that a person does no harm to members of his group if as a result of his effort he is better off and others are no worse off than they would otherwise be.

Several conclusions can be drawn from this. Firstly, Islam's concept of property rights is different, inasmuch as the individual has a delegated right to the property whose acquisition, usage and disposal are subject to rules including the principle of sharing as dictated by the *Shari'ah*. Secondly, while Islam fully recognizes the individual's private-property rights, these rights are governed by rules designed to protect the rights of society and the state. By virtue of the first and second axioms of property rights, every individual, group, community, society and the state becomes a stakeholder whose rights are granted and preserved by the *Shari'ah* in order to promote social order and economic development. While it is difficult to recognize or justify some rights of others in a formal economic theory in the conventional system without drawing any reference to ethics and morality, such a problem does not exist in Islam, where everyone's rights are recognized and protected by Law (*Shari'ah*). Finally, inclusion (or exclusion) and recognition (or denial) of the rights of stakeholders in the Islamic economic system are based on rules and laws that need no justification on the grounds of morality alone, but are derived from principles aimed at creating justice and balance in the economic and social system.

Whereas the *Shari'ah* guarantees some basic property rights to individuals by virtue of their being members of the society, the rights of a firm or a legal entity such as a corporation are earned and acquired. It is not the firm that acquires property rights, but it is the property acquired in the course of the firm's economic activity that has property rights and claims. Once a property is earned or acquired, it is subject to the same rules of sharing and the same prohibitions as apply to the property of individuals. The firm's property rights also come with the same claims and responsibilities as do



those of individuals. This implies that the firm is expected to preserve the property rights of not only the local community or society, but also of those who have participated in the process of acquiring or earning the firm's property. No action of the firm that violates the basic set of property rights of those with whom the firm interacts is acceptable.

The principles of property rights in Islam clearly justify the inclusion of stakeholders into the decision-making and accountability of an economic agent's activities. This inclusion is based on the principles that

- The collectivity (community, society, state) has sharing rights with the property acquired by either individuals or firms
- The exercise of property rights should not lead to any harm or damage to the property of others (including stakeholders)
- The rights of others are considered as property and are therefore subject to rules regarding violation of property rights
- Any property leading to the denial of any valid claim or right is not recognized as *al mal* and therefore is considered unlawful according to the *Shari'ah*.

### Contracts and Governance

As we saw from Chapter 2, the significance of contractual obligations in economic and social relations cannot be over-emphasized. The whole fabric of Divine Law is contractual in its conception, content, and application.

A contract in Islam is a time-bound instrument, which stipulates the obligations that each party is expected to fulfill in order to achieve the objective(s) of the contract. Contracts are considered binding and their terms are protected by the *Shari'ah* no less securely than the institution of property. The freedom to enter into contracts and the obligation to remain faithful to their stipulations has been so emphasized in Islam that a characteristic that distinguishes a Muslim is considered to be his faithfulness to the terms of his contracts. In the *Shari'ah*, the concept of justice, faithfulness (*amanah*, whose antonym is *khiyanah*, meaning "betrayal, faithlessness and treachery"), reward and punishment are linked with the fulfillment of obligations incurred under the stipulation of the contract.

The contractual foundation of the *Shari'ah* judges the virtue of justice of individuals not only for their material performance but also by the essential attribute of their forthright intention (*niyya*) with which they enter into every contract. This faithfulness to contractual obligations is central to Islamic belief. So basic is the notion of contracts in Islam that every public office is regarded primarily as a contract or agreement that defines the rights and obligations of the parties.

The emphasis placed on contracts in Islam, by implication, makes the members of society and economic agents aware of the obligations arising from their contractual agreements—verbal or written, explicit or implicit. In the case of explicit contracts, parties to the contract clearly stipulate the

expected behavior and duties with respect to the terms of the contract. This contract is to be free of information asymmetry; parties intend to comply with the terms of the contract and are fully aware of their rights and obligations. Importantly, the state ensures enforceability of the contract in case of violations by either party. On the other hand, implicit contracts are not formal contracts with clearly defined terms but are claims and obligations that come with the rights to be part of a society. The principles of sharing and the rights of the collectivity to property are types of implicit contracts to preserve and protect the rights of others and thus establish a wide spectrum of implicit obligations. Honoring these obligations is considered a sacred duty that provides the moral, social and legal foundation for recognizing and enforcing the obligations arising from implicit contracts.

Islam's framework of contracts places equal emphasis on obligations arising from both explicit and implicit contracts. Individuals as well as public and private entities are expected to be aware of this. Therefore, just as it is incumbent upon economic agents to honor explicit contracts, it is obligatory for them to preserve the sanctity of implicit contracts by recognizing and protecting the property rights of stakeholders, community, society and state. Whereas the conventional stakeholders' theory is searching for sound arguments to incorporate implicit contracts in the theory of the firm, in the Islamic economic system rights and obligations of stakeholders are taken for granted.

Islam's framework of property rights and contracts also establishes guidelines regarding who can qualify as a stakeholder and whether such a stakeholder has any right to influence the firm's decision-making and governance. In a broad sense, any group or individuals with whom a firm has any explicit or implicit contractual obligations qualifies as a stakeholder, even though the firm may have formal contracts with them through mutual bargaining. In Islam, a stakeholder is the one whose property rights are *at stake* or *at risk* as a result of the voluntary or involuntary actions of the firm. Where an individual's rights are encroached upon or threatened as a result of the firm's operations, that individual, group, community or society becomes a stakeholder.<sup>18</sup>

## **THE SIGNIFICANCE OF TRUST**

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The notion of trust was recognized by Fukuyama (1996) as an important component of social capital and a strong explanatory factor in the economic performance of industrial countries. The last decade has witnessed a growing literature covering the importance of trust to, *inter alia*, the development of the financial system (Calderon *et al.* 2002; Guiso *et al.* 2004). This body of research has demonstrated that since finance (particularly risk-sharing instruments such as equity) was trust-intensive, high-trust societies exhibited more developed and deeper financial systems. In particular, the literature indicated that there is a high correlation between trust and the

development of the financial sector. If the level of trust is high, people rely more on risky assets, such as equity, invest a larger share of their wealth in stocks, use more checks, and have access to greater amounts of credit than in low-trust countries. Importantly also, since the second half of the 1990s, a number of researchers, using a variety of techniques, have attempted to demonstrate the impact of trust on economic performance.

The *Qur'an* establishes human beings as the *khalifa* or trustees of God on earth, and life is a test of man's worth in the eyes of God (67:2). The divinely mandated command of faithfulness to the terms and conditions of contracts and abiding by their obligations is underpinned by the equally strong and divinely originated institution of trust.<sup>19</sup> There is a strong interdependence between contract and trust; without the latter, contracts become difficult to enter into and costly to monitor and enforce. Laws and expensive administrative apparatuses are needed to enforce contracts where trust is weak. Perhaps trust is emphasized to make entering into and enforcing contracts less costly. Accordingly, numerous verses in the *Qur'an* proclaim trustworthiness as a sign of true belief. Conversely, untrustworthiness and betrayal of trust are considered a clear sign of unbelief.<sup>20</sup>

Trust is important social capital which plays a vital role in promoting good governance, especially in the case of institutions dealing with financial services, which are given property to manage in "trust." Therefore, preserving high trust should be an integral part of the governance goals of business leaders and the holders of public office.

### High Ethical Standards and Codes of Conduct

Islam demands high standards of ethical behavior from everyone in society, but emphasizes these standards for who govern or represent others. Within the framework of economic justice, emphasis is placed on being mindful to give full measure and weight in all business transactions. Taken in conjunction with the principles of property rights, it establishes an important rule of business that full measure and weight is not limited to physical quantities but is equally applicable to measuring intangible rights and obligations. In other words, it is the responsibility of those in charge of others' property—tangible or intangible, financial or non-financial, explicit or implicit—to ensure that all obligations are accounted for with great care and all claims and rights are returned in full to the rightful recipient.

The verses which state "Woe unto those who give short measure, those who, when they are to receive their due from [other] people, demand that it be given in full but when they have to measure or weigh whatever they owe to others, give less than what is due!" (83:1–3) remind individuals against any negligence or cheating in determining what is owed to others. They refer not only to commercial dealings but encompass every aspect of social relations, both practical and moral, and apply to every individual's rights and obligations no less than to his physical possessions.<sup>21</sup>

The importance of fulfilling promises and obligations is emphasized time and again in the *Qur'an* (see, for example, 2:177 and 17:34). The grave consequences of not doing so correctly are also made clear (3:77).

Islam expects excellence in moral values, truthfulness, and virtuous conduct from every member of society, particularly those who are involved in business.<sup>22</sup>

### **Stakeholder-oriented Governance Structure**

In Islam, the behavior expected of a firm is not any different from the behavior of any other member of the society. Since the firm itself does not have a conscience, the behavior of its managers becomes the behavior of the firm and their actions are subject to the same high standards of moral and ethical commitment expected of a Muslim. In other words, the firm's economic and moral behavior is shaped by its managers acting on behalf of the owners and it becomes their fiduciary duty to manage the firm as a trust for all stakeholders and not for the owners alone. Consequently, it is incumbent upon the managers to ensure that the behavior of the firm conforms to the principles and rules of the *Shari'ah*. If there is any deviation, institutional arrangements discourage it. In an ideal situation where all agents are true believers whose behavior corresponds fully to the requirements of the *Shari'ah*, their faithfulness to the terms of contracts and accountability for respecting property rights will lead to the elimination of the problems arising from asymmetric information, moral hazard and adverse selection and thus guarantee optimal governance. In a less-perfect world where commitment to contracts may be influenced by personal interests at the expense of the interests of the collectivity, the design of the structure of governance has to ensure faithfulness to the agent's contractual agreements and the protection of everyone's rights.

The design of a corporate governance system in the Islamic economic system, therefore, entails implementation of a rules-based incentive system in which compliance with the rules ensures an efficient governance system to preserve social justice and order among all members of society. This implies institutions and rules that are designed to compel managers to internalize the welfare of all stakeholders. The rights that are claimed for stakeholders are not ends in themselves—which ought to be recognized in any form of economic organization—but a means of protecting constituency rights.<sup>23</sup> In an Islamic system, the observance of the rules of behavior guarantees the internalization of stakeholder rights (including those of the society at large). No other institutional structure is needed. It is the Islamic government that specifies the appropriate corporate governance structure, “incorporating all stakeholders' rights into fiduciary duties of managers” of the firm on behalf of none—investors or stakeholders. So no other institutional arrangement that would allow individual non-investor stakeholders to negotiate directly with the firm is necessary. Incorporating all stakeholders' rights into the

fiduciary duties of managers is counterproductive and leads to sub-optimal results. The important point is that each stakeholder is given the freedom of bargaining to protect their rights and there are systematic institutional arrangements in place to provide protection and to mediate where disputes and disagreements arise.

Institutional arrangements can be part of system-wide infrastructure surrounding the governance structure of the firm. For example, because contracts are invariably incomplete, judicial interpretations can fill in the gaps. It is permissible to regard employment law, consumer law, tort law, as well as judicial rulings and administrative regulations, as part of the contracts that various stakeholders have with the firm. Similarly, the concept of the *Shari'ah* boards, which ensure that the operations and code of conduct of the Islamic bank are in accordance with the rules of the *Shari'ah*, is unique to the Islamic financial system. However, having a board for every firm, as is the case at present, is not efficient, as only one set of rules is needed for all firms for appropriate corporate governance based on the *Shari'ah*. This same idea can be extended to a system-level board consisting of scholars from different disciplines including *Shari'ah*, economics, finance, and commercial law, to ensure that rules are so framed and enforced that economic agents fully comply with their contractual obligations to all the stakeholders.

To summarize, the Islamic economic system fully endorses a stakeholder view of governance based on Islam's principles of the preservation of property rights and the sanctity of contracts. The corporate governance model in an Islamic financial system can be derived from a comprehensive understanding of the principles of Islam.

### Quality of Leadership

In Islam, the behavior expected of a firm is no different from that expected of any other member of society. The firm's economic and moral behavior is shaped by its managers acting on behalf of the owners and it becomes their fiduciary duty to manage the firm as a trust. Consequently, it is incumbent upon managers to ensure that the firm's behavior conforms to the principles and the rules of *Shari'ah* and such compliance will ultimately lead to the development of trust, responsibility, and accountability.

*Shari'ah* governs the behavior of leaders no less stringently than that of individuals. Although each member of society is expected to exhibit high moral values in the observance of contracts and covenants, many scholars are of the view that these requirements apply with even greater force to the actions of leaders. Therefore, a breach of faith on the part of a leader is more heinous in its nature and more serious in its consequences than a similar breach by an ordinary individual.

The current financial crisis has highlighted the role of managers and corporate leaders in shaping the crisis: the lack of transparency, greed, misrepresentation, fraud, and breach of trust displayed by certain financial

managers and leaders all contributed to the chaos. Collins (2009) has observed the corporate behavior of leaders and identified the different stages they might go through during the course of a fall—from the hubris of considering success as an entitlement, to the undisciplined pursuit of more (more scale, more growth, more acclaim, more of whatever they see as “success”), to putting a positive spin on ambiguous data and being unable to accept responsibility for setbacks. Such behavior was prevalent across the industry in the lead-up to the current financial crisis.

Leaders who are fully conscious of their responsibilities, limitations, and obligations as expected in Islam would never fall into behavior which would promote arrogance, ignorance, greed, deceitfulness, non-transparency, and delinquency. To assist the development of leaders with higher moral and ethical values, integrity, introspection and humility, the governance infrastructure needs to be strengthened.<sup>24</sup> These principles define the social norms in Islam which determine the behavior expected of individuals and institutions and establish a set of socially approved values. While the values and expectations in any given society may shift or change with the passage of time, Islamic values are inviolable at all times. Therefore, these values set a benchmark against which the behavior of individuals and institutions will be judged.

## **CORPORATE-GOVERNANCE ISSUES OF IFIs<sup>25</sup>**

Corporate governance relates to the manner in which the business of the bank is conducted, including setting corporate objectives, the bank's risk profile, aligning corporate activities and behavior with the expectation that management will operate in a safe and sound manner, running day-to-day operations within an established risk profile, while protecting the interests of depositors and other stakeholders. It is defined by a set of relationships between the bank's management, its board, its shareholders, and other stakeholders.

The key elements of sound corporate governance in a bank include:

- A well-articulated corporate strategy against which the overall success and the contribution of individuals can be measured.
- Setting and enforcing a clear assignment of responsibilities, decision-making authority and accountabilities that are appropriate for the bank's risk profile.
- A strong financial risk management function (independent of business lines), adequate internal control systems (including internal and external audit functions), and a functional process designed to incorporate the necessary checks and balances.
- Adequate corporate values, codes of conduct and other standards of appropriate behavior and effective systems used for ensuring compliance. This includes special monitoring of the bank's risk exposures

where conflicts of interest are expected to appear (for example, relationships with affiliated parties).

- Financial and managerial incentives for the board, management and employees to act in an appropriate manner. (That is, compensation should be consistent with the bank's objectives, performance and ethical values).

Given the fiduciary nature of the financial industry and the scope of asymmetry in access to information, corporate governance arrangements may matter more for financial businesses than for other firms. In its essence, a financial business organization is a fiduciary trustee that is entrusted with the intangible assets of another party, specifically depositors and other investors. Therefore, it carries a special obligation to act in the best interests of that other party when holding, investing, or otherwise using the principal's property. This is crucial in the context of banking, where informational asymmetries are likely to be higher than in other firms.

The distinct nature of financial intermediation conducted by IFIs raises certain governance issues that require further discussion:

**Financial interests of account holders** Investors or depositors are among the most important stakeholders and protecting their financial interests is critical. In the case of current accounts, IFIs obtain an explicit or implicit authorization to use the deposit money for whatever purpose permitted by *Shari'ah*, but pay no return or profit to the depositors. Any negligence or misconduct on the part of IFIs can result in financial losses to current account holders. There should be proper procedures to ensure that the IFI's management does not go for risky investments or excessive use of these funds to enhance the performance of overall investments to benefit other unrestricted investment-account holders.

In the case of restricted investment accounts (RIAH), the bank acts only as fund manager—agent or non-participating *mudarib*—and is not authorized to mix its own funds with those of the investors without their prior permission. It is in the interests of RIAH that they are provided with all relevant information about the returns and risks. In addition, it is the responsibility of the management of IFIs to ensure that investments funded by RIAH are ring-fenced from the rest of the investments and there is full transparency in the identification and distribution of profits and losses. Similarly, unrestricted investment accounts, which constitute the majority of deposits, pose specific corporate-governance problems. It is a common practice of IFIs to place shareholders' and investment funds in common pools, without any mechanism to separate the two. Consequently, there is the concern that shareholder-controlled management and boards may favor and protect shareholders' investments at the expense of those of investment-account holders.

**IAHs as stakeholders** Investment account holders (IAHs) are like quasi-equity holders, but without any participation in the governance of the financial

institutions. As a result, IAHs do not have any direct means to protect their rights. Since they do not have any participation in the governance mechanism they are at the mercy of public policymakers, regulators and *Shari'ah* boards. A transparent and efficient governance arrangement should be devised to include and protect the rights of IAHs.

**IFIs as stakeholders** By design, a considerable portion of the IFIs' assets side could include profit/loss-sharing instruments, akin to those of *mudarabah* and *musharakah*. Because of the high degree of asymmetry of information in equity and profit/loss-sharing contracts, there is greater need for close monitoring of such investments by IFIs. Therefore, to minimize the cost of monitoring, there is need for institutional arrangements to facilitate monitoring and governance of such equity-based investments made by IFIs. The absence of such a governance mechanism is one of the reasons why the share of profit/loss-sharing instruments on the assets side of the IFIs is currently small.

Furthermore, the presence of profit/loss-sharing instruments creates a situation where financial institutions themselves become stakeholders in the businesses to whom they provide finance. This is similar to the "insider" system of governance as seen in the German model of banking, where bankers may also be represented on the board of directors or may participate in the management of the business. Although not much attention is paid to this aspect at present, it does impose an additional governance burden on the financial institutions.

**Governance of reserves** Maintaining reserves to smooth income over a period of time is becoming a common practice. The objective of the profit equalization reserve (PER) is to hedge against future losses or low income by keeping a portion of current profits to pay off investment account holders in the future. While this practice is in alignment with prudent risk management, it raises a governance issue that needs attention. Firstly, limited disclosure of such reserves makes investment account holders uneasy because they have no rights either to influence the use of such reserves or to verify the exposure of overall investments. Someone with long-term investment objectives may welcome this practice, but an investor with a short-term view may feel that he is subsidizing the returns of the long-term investor. Some banks (including the Islamic Bank of Britain) require investment account holders to waive their rights to these reserves.<sup>26</sup>

Islamic financial institutions should standardize the practice and the rights to these reserves should be clearly stated and explained to the depositors. One suggestion is that deduction from the profits belonging to investment account holders should apply only to long-term depositors, who are more likely to be exposed to such risk.

**The role of *Shari'ah* boards as stakeholders** As we have seen, *Shari'ah* boards take on a major responsibility and serve as stakeholders as they are the protectors



of the rights of investors and entrepreneurs who have put their faith and trust in the financial institution to perform specific economic activities.

IFIs have created structures and processes that reassure stakeholders on the conformity of all transactions and ensure compliance. A widely adopted approach is to have internal or independent bodies certify compliance with the *Shari'ah*. Each IFI has in-house religious advisers, collectively known as the *Shari'ah* Supervisory Board (SSB).<sup>27</sup> In principle, the prerogatives of the SSBs lie in five main areas:

- (i) The certification of permissible financial instruments through a *fatwa*<sup>28</sup> (*ex ante* audit),
- (ii) The verification of compliance with the *fatwa* (*ex post* audit),
- (iii) The calculation and payment of *zakat*,
- (iv) The disposal of non-compliant earnings, and
- (v) Advice on the distribution of income or expenses among the bank's shareholders and investment account holders. SSBs issue a report to certify the conformity of all financial transactions with these principles and this is usually an integral part of the IFI's annual report.

The role of *Shari'ah* boards in sound governance is critical—especially in regard to consistency of application. It is common practice in the current governance structure of IFIs to maintain a *Shari'ah* board or adviser for each institution. However, duplication of effort, and the lack of standardization and of competent *Shari'ah* experts make for inefficient decision-making processes. Instead, a system-wide board of knowledgeable religious scholars, who are also specially trained in Islamic economic and financial principles, would prove more efficient and facilitate an optimal governance structure. Such a board could work closely with regulators and supervisors to make sure that effective monitoring and supervisory controls are devised to protect the rights of all stakeholders in accordance with the spirit of Islam.

The functioning of internal SSBs raises a number of corporate governance issues, the first of which concerns the independence of the SSB from management. Generally, members of SSBs are appointed by the shareholders of the bank, represented by the board of directors. SSBs report to the board. Thus, they are employed by the bank, and their remuneration is proposed by the management and approved by the board. The SSB members' dual relationship with the IFIs as providers of remunerated services and as assessors of the nature of operations may create a conflict of interest. In principle, SSBs are required to submit an unbiased opinion in all matters pertaining to their assignment. However, their employment status generates an economic stake in the bank, which may have a negative impact on their independence.

Intertwined with this there may be issues of confidentiality because *Shari'ah* scholars sit on the SSBs of a number of IFIs. This multiple membership may be seen as a strength as it may enhance independence vis-à-vis a particular IFI. However, as it entails access to proprietary information about

different and possibly competing IFIs, it may give rise to another potential conflict of interest. SSB members are required to combine a diverse set of competencies, combining knowledge of Islamic law and commercial and accounting practices. In practice, it would appear that very few scholars are well-versed in both disciplines.

A further issue concerns consistency of judgment across IFIs, over time or across jurisdictions within the same IFI. In essence, the activities of an SSB are in the nature of creating jurisprudence by interpreting legal sources. As such, there may be conflicting opinions on the admissibility of specific financial instruments or transactions. However, the diversity of opinions is seemingly less widespread than would be expected. The Council for Islamic Banks and Financial Institutions (CIBAFI) sampled about 6,000 *fat-was*, and found that 90 percent were consistent across IFIs. The fact that these had been issued by more than a hundred *Shari'ah* scholars around the world suggests an overall consistency in the interpretation of the sources.<sup>29</sup> Nevertheless, as the industry expands, the number of conflicting rulings on the permissibility of an instrument is also likely to soar if no efforts are made to harmonize the standards. This may undermine the customer's confidence in the industry and have repercussions on the enforceability of contracts.

The last and overarching issue relates to disclosure of all the information relating to *Shari'ah* advisory. An objective of a stable Islamic corporate-governance system is to enhance the soundness of *Shari'ah* governance. The framework is enhanced by arrangements put in place by regulators and the presence of providers of financial-information services external to the firms. In addition, public rating agencies aid prudent disclosure by filtering out permissible investments and IFIs and are designed to create a positive climate for *Shari'ah*-compliant investments. However, private mechanisms for the external governance of *Shari'ah*-compliance are limited. Private rating agencies have not yet developed the necessary skills or found sufficient incentive to monitor compliance.

**Concentration of *Shari'ah* scholars** There is a dearth of qualified *Shari'ah* scholars in the market. In today's complex financial system, a person qualified to determine the authenticity of financial transactions requires in-depth knowledge of not only Islamic Law but also needs to be well-versed in the disciplines of economics, finance and banking. Reputable scholars are in high demand and as a result they end up committing themselves to multiple *Shari'ah* boards, which raises concerns about their capacity to meet the needs of existing and potential clients. The top 10 scholars currently occupy more than 40 percent of all board positions at international organizations and the top three scholars (Sheikh Nizam Yacoubi, Dr. Abu Guddah, and Dr. Ali Elgari) are, between them, on the boards of more than 200 Islamic funds. Table 15.1 lists the top 10 *Shari'ah* scholars and their affiliation with either international standard-setting institutions or with the private sector. This concentration of *Shari'ah* scholars reinforces the need to deal with the issues of independence, confidentiality and transparency discussed above.

**TABLE 15.1** Representation on *Shari'ah* Boards

Name of the scholar	Number of Positions at International Organizations	Number of Corporate Positions
Sheikh Nedham Mohamed Saleh Yacoubi	6	72
Dr. Mohammad Daud Bakar	6	32
Sheikh Dr. Abdul Satar Abdul Karim Abu Ghuddah	5	72
Dr. Ali Mohuddin Al'Qurra Daghi	5	26
Sheikh Abdullah Sulaiman Al Manee'a	4	34
Dr. Hussain Hamid Hassan	3	29
Justice Muhammad Taqi Usmani	3	14
Dr. Mohamed Ali Elgari	3	62
Dr. Ahmad Ali Abdulla	3	3
Sheikh Mohamed Ali Al-Taskheri	3	1

Source: Funds@work (2009)<sup>30</sup>

**Lack of standardization** Corporate governance practices are still evolving in several jurisdictions where Islamic banking and finance is being practiced and developed. For example, banking laws, rules to appoint board directors, accounting standards, and *Shari'ah* board practices are diverse across Muslim countries. Such heterogeneous environments pose challenges for existing and new business, regulators, and policymakers. This lack of standardization weakens the ability to enforce uniform treatment of laws and lessens the degree of transparency in the financial sector. Table 15.2 shows how diverse are the *Shari'ah*-compliance practices and framework in selected Muslim countries. It is clear from the table that there is lack of harmonization of standards and practices across these countries, which raises problems for the integration of Islamic financial markets with the conventional markets and the rest of international financial markets.

**Transparency** Transparency refers to the principle of creating an environment where information on existing conditions, decisions, and actions is made accessible, visible, and understandable to all market participants. Disclosure refers more specifically to the process and methodology of providing the information and of making policy decisions known through timely dissemination and openness. Accountability refers to the need for market participants, including the relevant authorities, to justify their actions and policies and accept responsibility for both decisions and results.

**TABLE 15.2** *Shari'ah*-compliance: practices and framework

Country	Islamic Banking Law	Shari'ah Committee			Fit & Proper Criteria for Shari'ah Adviser/Committee	Shari'ah Compliance Inspection	Shari'ah Standards	Accounting Standard
		At Central Bank	At Bank Level					
Malaysia	Islamic Banking Law 1983	Shari'ah Advisory Council	Shari'ah Committee	Approval by Bank Negara Malaysia (BNM)	Governance through Shari'ah Committee	All Products approved by SAC. Role of Shari'ah Committee defined by BNM	Accounting Standards developed by Malaysian Accounting Standards Board	
Bahrain	Regulations for Islamic Banks	Shari'ah Supervisory Committee	Shari'ah Supervisory Board	N.A	Internal and External Shari'ah Audit as per AAOIFI standards	AAOIFI	AAOIFI	
Indonesia	Laws for Islamic Banking introduced in 1992 and amended in 1999	National Shari'ah Board	Shari'ah Supervisory Board	NSB approves appointment of SSB members	Internal and External Shari'ah Audit	Fatwa on products issued by NSB	AAOIFI	

(Continued)

**TABLE 15.2** *Shari'ah*-compliance: practices and framework (Continued)

Country	Islamic Banking Law	Fit & Proper Criteria for <i>Shari'ah</i> Adviser/Committee			<i>Shari'ah</i> Compliance Inspection	<i>Shari'ah</i> Standards	Accounting Standard
		<i>Shari'ah</i> Committee					
		At Central Bank	At Bank Level				
Iran	Usury-free Banking Act 1983	Council of Guardians	N.A.	N.A.	No	Guidelines provided by Council of Guardians	Not Known
Brunei	Islamic Banking Act Cap.168	<i>Shari'ah</i> Financial Supervisory Board (SFSB)	<i>Shari'ah</i> Advisory Board	SFSB approves appointment of <i>Shari'ah</i> Advisory Board members	No	SFSB Approves Islamic products introduced by Financial Institutions	Not Known
Pakistan	Banking Companies Ordinance, 1962 and Policies for Islamic Banking in 2001 & 2003	<i>Shari'ah</i> Board	<i>Shari'ah</i> Adviser	Fit & Proper Criteria by State Bank of Pakistan	Manual developed in 2004, now being implemented	Essentials for Islamic modes	AAOIFI standards are being adapted by a committee of Institute of Chartered Accountants of Pakistan

Source: Akhtar (2006)

Islamic financial institutions have made considerable efforts to improve the level of transparency and the quality of information disclosure in the market in the last couple of years. However, there are still several areas that demand attention.

Analysts often have difficulty in collecting useful information regarding Islamic financial institutions. One of the factors contributing to this problem is the lack of uniform reporting standards followed by the financial institutions. For example, a study was recently conducted on the basis of a cursory survey of a sample of nine Islamic banks for which balance sheet data was easily available. It showed that only one bank did not provide sufficient details as to the division of equity and deposits. However, when it came to deposits, only five provided a detailed division of the deposit types that they offered, with the remaining three combining different types of deposits together. Of these three, two made no specific reference to special investment accounts, while the other one made no distinction between demand and saving deposits.<sup>31</sup> The disclosure practices are highly varied, as is the supervisor's authority to impose norms.

The collection and dissemination of relevant information and credit ratings need significant improvement. However, this requires an institutional infrastructure that facilitates the production of accurate financial information, the development of agents who can interpret and disseminate it, as well as arrangements to protect its integrity. Considering that reliable and timely information is critical for the Islamic financial system, the current level of infrastructure is not satisfactory. The existing limited infrastructure reduces the role that information flows may play in promoting competition and market activities that would induce managers to adopt sound corporate governance practices.

A transparent Islamic financial institution would ideally reveal the duties, decision-making, competence and composition of the *Shari'ah* board, as well as publish all *fatwas* issued by it. This would strengthen stakeholders' confidence in the credibility of the board's assessments. In addition, public disclosure would provide a venue for educating the public and pave the way for a larger role for market discipline with respect to *Shari'ah* compliance. Again, this aspect of transparency is missing from the market. Often, annual reports of the *Shari'ah* boards are not easily available to the public and other relevant information regarding *fatwas* is not made available.<sup>32</sup>

The application of financial modeling to the measuring of asset/liability risks is very limited. The use of quantitative methods such as VaR and PaR (discussed in an earlier chapter) can enhance financial disclosure, especially in the area of credit and equity risk. Risk exposures can provide information to the investors about their expected profits and losses.

## **LESSONS FROM THE CURRENT FINANCIAL CRISIS**

*“Corporate governance is one of the most important failures behind the present financial crisis.”*

de Larosière Group (2009)

*“This Report concludes that the financial crisis can be, to an important extent, attributed to failures and weaknesses in corporate governance arrangements.”*

OECD report (2009)

The current financial crisis is not simply the result of market failure: it was brewing for some time as a result of a gradual deterioration of business leadership, of lapses in governance and in the regulatory framework (particularly in derivatives markets), and of an ineffective risk management framework. Even the International Corporate Governance Network (ICGN) has argued that although corporate governance failures did not cause the financial crisis, they certainly aggravated it.<sup>33</sup>

There is consensus among researchers that the regulatory and supervisory framework was not adequate to the task of forecasting and preventing the crisis and there is a growing realization that the derivatives and structured products markets need regulation. Work is under way to address this particular issue in US and European markets. However, the crisis has highlighted other governance issues: the market discipline mechanism proved to be too weak; the decision-making of corporate leaders was overly driven by short-term goals; trust in corporate leadership declined; corporate boards were slack in their oversight and risk control; business ethics and values were compromised; and, finally, the corporate incentive and remuneration system was questioned. Key issues arising from this are summarized below.

### **Failure of Market Discipline**

The financial crisis has delivered a blow to the widely held view that the invisible hand of the market would work to make market players resolve conflicts through market discipline and that there was therefore no need to regulate the market. It was soon realized that not only was financial market information incomplete but that the market could be manipulated by market players for their personal interests.<sup>34</sup> This observation is particularly applicable to the derivatives and structured markets, where the level of complexity is higher than in markets for other financial products.

### **Short-sighted Approach**

There is a growing realization that financial firms, capital markets, and other large corporations are driven by the sole objective of maximizing share value. The de Larosière Group (2009) pointed out that “the financial

system at large did not carry out its tasks with enough consideration for the long-term interest of its stakeholders. Shareholders' pressure on management to deliver higher share prices and dividends for investors meant that exceeding expected quarterly earnings became the benchmark for many companies' performance."<sup>35</sup>

### **Breach of Trust**

The current financial crisis has done significant damage to aspects of social capital. The Edelman Trust Barometer, which tracks the level of trust in different countries, observed that people began to lose trust in business leaders and became critical of their irresponsible actions, especially in the US.<sup>36</sup> In the United States, home to some of the largest corporate collapses, trust in business leaders dropped 20 percentage points as a result of the crisis. At just 38 percent, this was even lower than the levels witnessed during the Enron and dot-com crises and came close to the levels in Western Europe, which has historically displayed the lowest trust levels in business among all nations surveyed by the tracker.

### **Failure of Board Oversight**

The role of board oversight in the governance structure is critical in financial institutions and there was considerable debate over the levels of remuneration being paid to board members even before the current financial crisis. The failure of boards to determine and monitor the strategy and risk appetite of the company and to respond in a timely manner was evident in many cases. Even when there was a proper risk management framework in place, boards failed to take timely action. Although the role of the boards of financial institutions has increased dramatically over the last decade, they have been criticized for being too complacent and unable to prevent collapses.<sup>37</sup> A recent G-20 report concluded that "the current financial crisis is a classic example of board failure on strategy and oversight, misaligned or perverse incentives, empire building, conflicts of interest, weaknesses in internal controls, incompetence and fraud."<sup>38</sup>

### **Failure of Risk Controls**

Weaknesses in safeguarding against excessive risk-taking behavior in a number of financial services companies were exposed during the current financial crisis. Even when the risk models gave signals of trouble, lax corporate governance meant that often no action was taken by senior management because such information never reached them or they judged it to be of little importance. While the failure of certain risk models can be put down to technical assumptions, the way in which the information was used in organizations was also a major contributor to this.<sup>39</sup>



### Deteriorating Business Ethics and Values

The current financial crisis has also highlighted the issue of a decline in moral and ethical values in senior management, who seemed to care more about circumventing regulatory constraints and finding loopholes in the law than about morally correct behavior. Increasing greed and personal empire-building became the norm on Wall Street, with little emphasis being placed on producing moral and ethical business leaders.

The following reflections on some of the corporate governance issues identified during the crisis may be of benefit to Islamic financial institutions.

- In general, if corporate governance is designed and practiced following Islamic principles governing property rights, contracts, and higher ethical and moral standards, the intensity of several of the issues confronting the conventional framework will be reduced. While conventional finance also expects business leaders to exhibit ethical behavior, it does not have a sound enforcement mechanism other than market discipline, which has come under attack during the current financial crisis. On the other hand, the Islamic financial system derives its values from the teachings of Islam and can expect ethical governance from leaders, managers, and other stakeholders, who follow the rules prescribed by *Shari'ah*. Promoting ethical governance fosters trust and formal governance mechanisms will become more effective in protecting the interests of stakeholders.
- Islamic financial institutions should increase transparency and disclosure, both internally and externally. Implementing transparency and corporate governance standards designed by international institutions such as the AAOFI and IFSB can enhance transparency in the system. Table 15.3 shows the guiding principles adopted by the IFSB for the governance of institutions offering Islamic financial service. All countries where Islamic finance is practiced should consider implementing these principles. The IFSB has issued similar guidelines for institutions offering *takaful* and Islamic funds.
- Islamic financial institutions should take risk management seriously. They should put in place mechanisms to measure and monitor risks and ensure that all types of risks (market, credit, liquidity, operational) are reported in timely fashion. Generating reports is the first step but the institutions should ensure that these risk reports are duly reviewed by senior management and board members. There should be mechanism to take timely action after the review.

There is no denying that good governance promotes economic growth and financial stability in the Islamic and conventional financial systems alike. Despite considerable progress being made in strengthening governance in the conventional system, the current financial crisis has highlighted several shortcomings. The governance principles of Islam are much broader in recognizing and including stakeholders. The ultimate objective of the Islamic

**TABLE 15.3** IFSB's guiding principles on governance of institutions\* offering Islamic financial services (IIFS)

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- Principle 1.1:** IIFS shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IIFS's accountabilities to various stakeholders.
- Principle 1.2:** IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognized accounting standards which are in compliance with *Shari'ah* rules and principles and are applicable to the Islamic financial services industry as recognized by the supervisory authorities of the country.
- Principle 2.1:** IIFS shall acknowledge IAHs' right to monitor the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised.
- Principle 2.2:** IIFS shall adopt a sound investment strategy which is appropriately aligned to the risk and return expectations of IAH (bearing in mind the distinction between restricted and unrestricted IAH), and be transparent in smoothing any returns.
- Principle 3.1:** IIFS shall have in place an appropriate mechanism for obtaining rulings from *Shari'ah* scholars, applying *fatwa* and monitoring *Shari'ah* compliance in all aspects of their products, operations and activities.
- Principle 3.2:** IIFS shall comply with the *Shari'ah* rules and principles as expressed in the rulings of the IIFS's *Shari'ah* scholars. The IIFS shall make these rulings available to the public.
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\*Corporate governance: A defined set of relationships between a company's management, its Board of Directors, its shareholders and other stakeholders which provides the structure through which (i) the objectives of the company are set; and (ii) the means of attaining those objectives and monitoring performance are determined.

Source: IFSB (2006)

system is to enhance social justice and welfare. To this end, it expects the highest moral and ethical conduct from the business leadership as well as from policymakers, regulators, and industry participants.

The governance framework, as defined by the principles of Islam, will focus on achieving the objectives of *Shari'ah*: the promotion of social justice, unity and social cohesiveness; the curbing of counterproductive behavior such as greed, deceit, misrepresentation, and the misappropriation of property; a strong commitment to contractual obligations; and transparency in decision-making. Such a structure is crucial to the stability of any financial system.

## ENDNOTES

1. Al-Jarahi (2000).
2. Mirakhor (1989).
3. Boatright (2002).

4. Zingales (1997).
5. Donaldson and Preston (1995); Freeman (1984).
6. *Shari'ah* scholars consider that the human self or soul (*nafs*) has "rights" as well as many duties and responsibilities.
7. Imam Zayn al-Abidin's treatise on rights, *Risalat Al-Huquq*, covers a full spectrum of rights in Islam. For example, the right to one's property (*al-mal*) means that one takes it only from what is lawful and spends it only on what is proper. The right of the associate (*khalit*) is that one neither misleads him, nor acts dishonestly toward him, nor deceives him. The right of the adversary (*khasm*) who has a claim against one is that, if his claim is valid, one gives witness to it against oneself. See Ali ibn al-Husayn (1990).
8. Islam (1999). The term "*mal*" or its derivatives are mentioned in more than 90 verses in the *Qur'an* and in numerous sayings of the Prophet (pbuh).
9. See Mirakhor (1989) and Ahmed (1995).
10. Allah (*swt*) explicitly states that "Believe in Allah and His messenger, and spend of that whereof He made you trustee." *Qur'an* (57:7). By implication, the ownership of property (*al-mal*) is understood to be a trust and is considered to be a test of faith. See Bashir (1999).
11. Mirakhor (1995) makes reference to a number of verses to support this axiom.
12. Islahi (1988) claims that this distinguishing characteristic of his economic views is not found in any other scholars.
13. The Prophet (pbuh), during his last sermon at Arafat, declared the inviolability of property to be at par with that of life and honour: "Like this day of this month in this territory, sacred and inviolable, Allah (*swt*) has made the life and property and honor of each of you onto the other until you meet your Lord." This is further endorsed by the *hadith* stating that "Muslims' blood, property and dignity are protected against each other."
14. Islahi, op. cit.
15. These rules are supported by various verses in the *Qur'an*: see, for example, 2:188, 17:27 and 25:67.
16. The concept that man has an unrestricted handling authority over his wealth is unacceptable. Allah (*swt*) condemned the people of Shuayb for adopting such an attitude. See the *Qur'an* (11:87). Ahmed (1995).
17. Bashir (1999) argues that Islam attaches great importance to protecting people from harm caused by others. The Prophet (pbuh) is reported to have said "to cause harm to others is not allowed in Islam."
18. The classical definition of stakeholders is given by Freeman (1984) as any group or individual who may affect or be affected by the attainment of the firm's goals. Clarkson (1995) offers a refined view of a stakeholder based on the stakeholder's exposure to the risk (a hazard, a danger, or the possibility of suffering harm or loss) as result of the firm's activities.
19. Iqbal and Mirakhor (2007); Kourides (1970).
20. Verses of the *Qur'an* dealing with trust are: 2:27; 2:40; 2:80; 2:177; 2:282-83; 3:161; 4:107; 4:155; 6:153; 7:85; 8:27; 8:58; 9:12; 9:75; 9:111; 11:85; 13:20; 16:91; 16:94; 16:95; 17:34; and 23:8.
21. Asad (2004).
22. Dr Sabahuddin Azmi, <http://www.renaissance.com.pk/Mayviewpoint2y5.htm>.  
The significance of high morals and good was reinforced by the Prophet (pbuh)

- who said: “The truthful merchant [is rewarded by being ranked] on the Day of Resurrection with prophets, veracious souls, martyrs and pious people” (Tirmidhi, No: 1130).
23. Boatright (2002).
  24. Considering the fact that several of the “renowned” corporate leaders involved in the current financial crisis are graduates of top academic institutions in the US, including the Harvard Business School, a national discussion has started to review academic programs. Schools have also started to make one course in corporate responsibility a requirement for graduation.
  25. See Grais and Iqbal (2006); Iqbal (2006); and Greuning and Iqbal (2006) for further details.
  26. Grais and Pellegrini (2005).
  27. They exist in all Islamic countries with the exception of Iran, where compliance of the whole banking system with the *Shari’ah* is guaranteed and monitored by the central bank.
  28. A *fatwa* is a religious edict or proclamation. It is a legal opinion issued by a qualified Muslim scholar on matters of religious belief and practice.
  29. Grais and Pellegrini (2005).
  30. *Shari’ah* Scholars—A Network Analytic Perspective, 12th April 2010, Version 4.0, Funds@Work.com
  31. Ibid.
  32. Ibid. A survey of 13 IFIs shows the level of transparency to be low. All 13 declared the existence of an SSB within the organization and disclosed information on its composition. However, only seven made the annual report of the SSB easily accessible and seven did not provide detailed information on the professional background of the SSB members. Moreover, only two IFIs disclosed the *fatwas* authorizing the provision of financial services and products. Only one disclosed provisions for decision-making and interaction with other bodies of the firm. Finally, only one IFI disclosed on its website the duties and obligations of the SSB. The IFIs’ practice of limited disclosure would not inspire confidence in *Shari’ah* compliance.
  33. Van Den Berghe (2009).
  34. Ibid.
  35. Ibid.
  36. Edelman (2009).
  37. Van Den Berghe (2009).
  38. Becht (2009): 2.
  39. Kirkpatrick (2009).

## CHAPTER 16

# Globalization and its Challenges

**T**he last few decades have witnessed dramatic and rapid changes in the structure of financial markets and institutions across the world. Advances in financial theory, the rapid pace of financial innovation, the revolution in information technology, deregulation, and institutional reforms have changed the nature of financial relations irreversibly and a “new finance” has emerged. As a result:

*. . . people can borrow greater amounts at cheaper rates than ever before; invest in a multitude of instruments catering to every possible profile of risk and return, and share risks with strangers from across the globe. These changes have altered the nature of the typical transaction in the financial sector, making it more arm's length and allowing broader participation. Financial markets have expanded and have become deeper. The broad participation has allowed risks to be more widely spread throughout the economy.<sup>1</sup>*

The new finance has an important role in leveling the economic playing fields, thus becoming the great equalizer of our time: it requires no passport, and does not discriminate on the basis of color, creed, race, or national origin. It unwinds and unbundles, dissects, analyzes, and prices risk, and searches for the highest return. It explores all opportunities for risk/return sharing, in order to exploit the wedge between the real rate of return to assets and the real rate of interest, leading to a greater reliance on risk sharing.

Globalization is a multifaceted and multidimensional process of growing interconnectedness among nations and peoples of the world. Its main dimensions are cultural, socio-political, and economic. Its economic dimensions include growing trade flows, unhindered movements of finance, investment and production, accompanied by the standardization of processes, regulations, and institutions—all facilitated by the free flow of information and ideas. Globalization is the result of reduced information and transportation costs, and the liberalization of trade, finance, investment, capital flows, and factor movements.

As globalization gathers momentum and becomes pervasive, and as more economies liberalize in order to integrate into the global economy, the new finance will grow and so will risk sharing and asset-based securitization: both are at the core of Islamic finance. The present globalization is considered unfair because the risks and rewards of the process are not shared equitably. However, as equity-based and asset-backed financing grows, the fruits of globalization can be distributed more widely and more equitably among the participants than has been the case thus far, at least in terms of the financial linkages. There remains the question of protectionism in industrial countries, segmented labor markets and impediments to the transfer of technology, which require full international cooperation to be addressed and mitigated.

If the present globalization process is characterized as the free flow of trade, investment, and production, then it is possible to identify a similar episode of globalization—that of the Middle Ages. During the period referred to as “the age of the commercial revolution,” from the middle of the eighth century to the latter part of the sixteenth century, trade flowed freely across the known world, supported by risk-sharing methods of finance, which were developed in the Muslim countries consistent with the *Shari’ah*. Information regarding the basic features of these methods was transmitted from the Muslim world via the intermediation of Jewish scholars and merchants, and from Spain, to Egypt, Europe, India, and North Africa. These new financial techniques were also transmitted by Muslim merchants to Eurasia, Russia, China and East Asia.

As globalization proceeds, its main engines—the new finance and advances in information technology—will shift the methods and instruments of financing trade, investment, and production in favor of more risk spreading and risk sharing, rather than risk shifting via fixed price debt contracts. This is the result of financial innovations that are dissecting, analyzing, and pricing risk better, so that—combined with efficient availability of information and the adoption of best international standards of transparency, accountability, and good governance in the public and private sectors—the *raison d’être* of fixed-price debt contracts will erode.

The current wave of globalization is here to stay and will change the financial landscape. As the new financial landscape emerges, risk-sharing and ultimately profit/loss-sharing contracts will become standardized, which will create opportunities for new financial systems to develop. Globalization and consequently the expansion of equity and risk-sharing modes of financing should pave the way for the further growth of Islamic finance. However, for this to happen Islamic finance has to overcome the several challenges that have been discussed in previous chapters and are summarized below.

## **CHALLENGES FOR ISLAMIC FINANCE**

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There are challenges on several fronts; theoretical, operational, and implementational. On the theoretical side, further work needs to be done on

developing core principles of Islamic economics, and understanding the functioning of a financial system operating on a profit/loss-sharing basis. On the operational side, issues relating to innovation, intermediation, and risk management are worthy of attention. Special attention should also be given to a system-wide implementation. Each of these challenges could take up a volume of its own, but for our purposes a brief discussion of some of these challenges will have to suffice.

### **Refining Islamic Economics**

Whether Islamic economics is considered to be an entirely different discipline from traditional economics—a position justified by its world view, its view of rationality, its view on man's nature, its emphasis on the need for correspondence between behavior and prescribed rules, as well as its other specific dimensions—or as a special sub-field within that discipline, it has made considerable progress since its revival a little over three decades ago. This is remarkable, given that there is virtually no organized support for this effort, in sharp contrast to the multitude of private and public foundations providing financial support to research traditional economics. Despite the wealth of resources available in many Muslim societies, there is lamentably little support for scholarship in Islamic economics. Moreover, even the academic recognition of research activities in this field is, by and large, lacking and there is a lack of incentives for scholars to pursue their interest in furthering contemporary thinking in the discipline. Nevertheless, the personal dedication of scholars has produced a credible body of work that provides a sense of optimism regarding the future of Islamic economics.

There is no reason to doubt that scholarly activities in this field will continue and that, at some point in the future, it will develop a rigorous analytic foundation for policy analysis and prescription to achieve the objectives of Islam for the economy. Learning from the history of development of traditional economics—both its successes and failures—research in Islamic economics should anchor its progress on an interdisciplinary approach, paying due attention to historical, philosophical, psychological, and sociological dimensions of what Islam intends for individual and collective economic behavior. The immense scholarly works of Muslim philosophers, *fuqaha*, historians, and social critics provide a valuable legacy that will be extremely helpful in this process. Developments in traditional economics are also a fertile field for researchers in Islamic economics to harvest as a source of ideas. While the economic history of Muslim societies and thought can serve as a major source of ideas, special attention should also be directed at developing a proper language of discourse in Islamic economics, with the hope of the emergence of consensus-based, analytical, and operational definitions, and descriptions of major concepts that scholars need in order to further refine ideas and generate new insights. A common language, with its own “grammar” of Islamic economics, is fundamentally important. For this reason, a plea is made for the development of a coherent,

comprehensive, and systematic economic hermeneutics as a foundational structure that supports research, dialogue, and debate in Islamic economics, as well as in building the future edifice of theoretical, empirical, and policy structure of this discipline. The present generation of researchers is in a position to make an important contribution by focusing on activities that can draw economic meanings and inferences from terms, ideas, and concepts expounded in the sources of Islam. The hope is that at some point a collection similar to *Palgrave's Dictionary of Economics* is developed for Islamic economics. The momentum of these efforts will be greatly accelerated if financial resources, similar to those provided to investigations in traditional economics by major foundations, could be mobilized in Muslim societies to support such activities.

### **Trust, Institutions and Economic Development**

Recent cross-country research indicates that the best-performing countries are those with relatively high trust levels and strong institutions. In poor-performing economies the level of trust is low, and institutions are either absent or weak. If trust is low, strong institutions should be established to protect property and investors' rights as well as to enforce contracts. While current Muslim societies have low levels of trust, they are adopting best practice and international standards of policy formulation and implementation, as well as legal institutions and practices that compensate for this weakness. Therefore, it is expected that risk-sharing methods of Islamic finance will expand rapidly in these countries.

As mentioned earlier, an important reason for the dominance of risk-sharing finance during the Middle Ages was mutual trust. It is possible that the breakdown in the general level of trust relationships may have led to the dominance of debt contracts beginning at the end of the Middle Ages. Economists, however, have been empirically investigating trust only recently after Fukuyama (1996) raised the possibility that it may be an important factor in explaining cross-country economic performance. Specifically, he asserted that the general level of trust, an important component of social capital, was a strong explanatory factor in the economic performance of industrial countries. Moreover, he indicated that a high level of general trust was reinforced in these societies by strong institutions. The last decade of the twentieth century had already witnessed a large volume of empirical research that focused on the existence (or the lack) of strong institutions explaining cross-country differences in economic performance. This literature isolated two specific institutions—those that protect property rights and those that enforce contracts—as the most important in explaining why some economies performed well and others did not.

As we saw in the previous chapter, the last decade has witnessed a growing literature on the importance of trust to the development of the financial system. There is growing evidence to suggest that low trust is a crucial factor in explaining the low level of stock market participation. If such research proves robust, trust may well become the long-awaited solution to the Equity Premium Puzzle (see following section). Trust may be defined



as the subjective probability that individuals attribute to the possibility of being cheated. Based on the analysis of cross-country data, where the level of trust is high, investment in equities in general, and in the stock market in particular, is also high. In low-trust countries, equity participation depends on observance of the rule of law and the existence of legal institutions that protect property and investor rights and those that enforce contracts. It suggests that in low-performing economies not only is the level of trust low, but property and investor rights are poorly protected, and legal enforcement of contracts is weak. Consequently, in these countries, corporations either do not form or, if they do, they resort to debt financing. The policy implications for these economies are that they should strengthen legal institutions, improve transparency, accountability, and governance—in both private and public sectors—and provide the public with a greater amount of information and education on risk/reward-sharing finance, particularly in equity markets.

The results of this recent research are a wake-up call for Muslim countries, since, as we have seen, trust is considered the most important element of social capital in Islam, and the cornerstone of the relationship of individuals with the Supreme Creator and with others in society. In short, Islam has made trust and trustworthiness obligatory—as well as keeping faith with contracts and promises—and has rendered them inviolable without explicitly permissible justification.

The reason for the poor economic performance of some countries is a low level of trust, combined with weak legal institutions protecting property and investor rights and poor contract enforcement. In the case of Muslim countries, Chapra (2000) has argued that this is attributable to weak adherence to the rules, norms, and values demanded by Islam. There is hope that as Muslim societies continue the process of strengthening legal institutions, their economic performance will improve. Efforts at reforming education, concentrating on adherence to Islamic values, norms and rules should strengthen the social capital—including, importantly, the level of trust—in these countries. One result of this will be the adoption of Islamic financial techniques of sharing risk/reward. Consequently, a global convergence process may be already at work toward risk sharing in the West and in the Islamic world. As the risks of globalization are shared more equitably, so will be its rewards, at least in respect of financial transactions and investment.

While the present low economic performance in Muslim societies, attributable to the low level of trust, is discouraging, signs are emerging that the future is more hopeful. The governments of these countries are implementing policies to strengthen the institutional structure of society, even if it is clear that the required level of trust will take a prolonged and sustained effort to achieve the strength commensurate with Islamic teachings. These policies include:

- Strengthening transparency, accountability, and good governance for public and private sectors

- Enacting fiscal responsibility and capital market laws
- Instituting legal structures that protect property and investor rights and enforce contracts
- Implementing financial-sector reforms that create a level playing field for all participants and deepen these markets
- Liberalizing trade and foreign direct investment.

Depending on the speed of such reforms, it is possible for Muslim countries to achieve much higher growth rates for their economies.

### **Emergence of a Risk Sharing Financial System**

The question remains as to why greater use is not made of equity finance, with its risk-sharing characteristics. Prescott and Mehra (1985) demonstrated that, over many decades, there was a large differential between the real rate of return to equity and the real rate of return to a safe asset; that is, US Treasury bills. Furthermore, the differential was too large to be explained by existing theories of rational investor behavior. This result became known as the “Equity Premium Puzzle.” It is a puzzle why rational investors, noting the differential, would not invest in equities until the point where the remaining differential could be explained as the risk premium on equities. Subsequent research demonstrated that the puzzle existed in other countries as well. A large body of literature has attempted to explain the puzzle but, as Mehra (2004) argued, all explanations failed, for one reason or another, to provide a satisfactory resolution.<sup>2</sup>

A major economic historical puzzle is why, after dominating the world of finance for eight centuries, risk sharing methods lost their supremacy to debt-based financing. One important reason may be that, since risk sharing is trust-intensive, a systemic breakdown of trust in Europe and elsewhere led to the emergence of debt-based financing. It is likely that this breakdown was a major factor for the decline of risk-sharing finance by the end of the Middle Ages.

While risk sharing techniques continued to be used in Europe until the mid-seventeenth century, interest-based debt financing began to be used more widely from the middle of the sixteenth century. There have been various explanations for this, including:

- The lifting of the scholastic prohibition on usury.
- The appearance and rapid growth of fractional-reserve banking that led to specialization of finance by intermediaries who preferred to provide financing to agent-entrepreneurs at fixed interest rates based on contracts enforceable by law in order to reduce monitoring and transaction cost.
- The inflow of gold and other riches into Europe from the European colonies in the Americas and elsewhere. This immense inflow reduced the incentive for the elite classes to continue financing trade on the basis of risk sharing. Instead, they preferred to turn their wealth over

to intermediaries, or to loan directly to merchant entrepreneurs on the basis of fixed-interest debt contracts.

- The emergence of nation-states whose governments were in need of finance for wars or other state activities, but could not raise resources except by means of fixed interest-rate contracts which paid an annuity in perpetuity without the need for governments to repay the principal.

However, this new system was inherently fragile.<sup>3</sup> Toward the end of the 1970s and the early 1980s, the existence of financial intermediaries in general, and banks in particular, was justified by their ability to reduce transaction and monitoring costs and to manage risk. However, little attention was paid to the reasons why banks operated on a fixed-interest system that rendered the system fragile and unstable and requiring a lender of last resort to regulate it. With the development and growth of information economics and agency literature, another explanation was added to the list of reasons for the existence of intermediaries: they served as delegated monitoring and signaling agents to resolve the informational problems, including asymmetric information that existed between principals and agents.

Based on the findings of the developing field of information economics, it is argued that adverse selection and moral hazard effects in a banking system operating on the basis of fixed-interest contracts in the presence of asymmetric information mean that some groups will be excluded from the credit market even when the expected rate of return for these groups may be higher than for those with access to credit. Furthermore, it is argued, in the case of risk/return sharing, contracts are not subject to these effects and that “the expected return to an equity investor would be exactly the same as the expected return of the project itself.”

The fragility of a financial system operating on the basis of a fixed, predetermined interest rate was underlined by Stiglitz (1988: 312) who argued:

*[I]nterest rate is not like a conventional price. It is a promise to pay an amount in the future. Promises are often broken. If they were not, there would be no issue in determining creditworthiness. Raising interest rates may not increase the expected return to a loan; at higher interest rates one obtains a lower quality set of applicants (adverse selection effect) and each one's applicants undertakes greater risks (the adverse incentive effect). These effects are sufficiently strong that the net return may be lowered as banks increase the interest rates charged: it does not pay to charge higher interest rates.*

The findings of the new field of information economics strengthened the arguments that a debt-based financial system with fractional-reserve banking operating with a fixed, predetermined interest-rate mechanism at its core is inherently fragile and prone to periodic instability. Stiglitz's findings underlined Minsky's argument that, as returns to banks declined, unable to

raise interest rates on their loans, they enter a liability management mode by increasing interest rates on their deposits. As this vicious circle continues to pick up momentum, the liability management transforms into Ponzi financing and eventually into runs on banks. The last two decades of the twentieth century witnessed a number of global bouts of financial instability and debt crises, with devastating consequences for a large segment of humanity, thus drawing attention to the vulnerabilities and fragilities of the financial system which originate, at their core, from fixed-price debt contracts. The risks of country-specific debt crises with potential risks of contagion have not diminished, particularly for a number of emerging economies, including some Muslim countries.

In the Middle Ages, Islamic modes of finance—based on mutual trust between agents and principals—dominated the known world. The breakdown of trust may have been crucial among the factors that explain the decline in risk sharing finance and the eventual dominance of fixed-price debt-contracting modes of finance. In modern financial markets, we observe a trend more favorable to risk sharing instruments. The rapid progress in development of risk sharing techniques and asset-backed instruments is evidence of this shift; in particular, there is already a perceptible shift of household portfolios toward equity and shareholding in a number of industrial countries. Risk sharing is also gaining momentum in discussions since the subprime financial crisis. As risk sharing financial instruments gain wide acceptance and the confidence of investors, it is possible to envisage a financial system founded on risk sharing as promoted by Islamic finance.

### **System-wide Implementation**

The most important challenge facing the Islamic financial system is to secure system-wide acceptance and implementation. At present, many Islamic countries suffer from financial disequilibria that frustrate attempts at wholesale adoption of Islamic finance. Financial imbalances in the fiscal, monetary, and external sectors of these economies cannot provide a fertile ground for the efficient operation of Islamic finance. Major structural adjustments, particularly in fiscal and monetary areas, are needed to provide a level playing field for Islamic finance. The efficient operation of system-wide Islamic banking is presently severely constrained by distortions in the economy, such as:

- Pervasive government intervention and controls
- Inefficient and weak tax systems
- Financial repression
- A lack of capital markets and a strong supervisory and prudential regulatory framework
- The lack of a well-targeted and efficient social safety net
- A shortage of legal and institutional frameworks that provide *Shari'ah*-based definitions of property and contractual rights.

These distortions need to be eliminated to minimize waste and promote efficient resource allocation. Their removal prior to, or in conjunction with, the adoption of Islamic banking should create the dynamics necessary for non-inflationary and sustainable economic growth.

These distortions not only increase price instability but also aggravate the risk and uncertainty surrounding contracts that do not promise a fixed nominal return. Since Islamic modes of transaction shift more risks to the investor, the investor needs credible government policies to maintain stable prices. The choice of a monetary and fiscal policy regime determines the types of risks and uncertainty that the society bears. Individuals reduce the costs of risks and uncertainty by opting for safe assets with fixed nominal payoffs, rather than returns that are dependent on outcomes.

An Islamic financial system can be said to operate efficiently if the rates of return in the financial sector correspond to those in the real sector. In many Islamic countries, fiscal deficits are financed through the banking system. To lower the costs of this financing, the financial system is repressed by artificially maintaining limits on bank rates. Thus, financial repression is a form of taxation that provides governments with substantial revenues. To remove this burden, government expenditures have to be lowered and/or revenues raised. Massive involvement by governments in the economy makes it difficult for them to reduce their expenditures. Raising taxes is politically difficult. Thus, imposing controls on domestic financial markets becomes a relatively easy means of raising revenues. Under these circumstances, governments impose severe constraints on private financial operations that can provide higher returns to their shareholders and/or depositors. This makes it very difficult for Islamic banks and other financial institutions to fully realize their potential. For example, *mudarabah* companies that can provide higher returns than the banking system end up in direct competition with that system for deposits that are used for bank financing of fiscal deficits.

While it has been relatively easy to create a system in which deposits do not pay interest, the asset portfolios of Islamic banks do not contain sufficiently strong components that are based on profit sharing. This is because there is a lack of legal and institutional frameworks that facilitate appropriate contracts as well as mechanisms to enforce them. The banking system is a direct function of the returns to asset portfolios and, since assets are created in response to investment opportunities in the real economy, it is the real sector that determines the rate of return to the financial sector rather than the reverse. This is compounded by the limited range and variety of maturity structures of financial instruments currently available.

Consequently, there is a perception that profit sharing methods in particular and Islamic finance in general are high risk. This, in turn, has led to a concentration of the asset portfolios of the Islamic banks in short-term and trade-related assets. The problem is exacerbated by the fact that Muslim countries lack the deep and efficient capital and money markets that can provide the necessary liquidity and safety for existing assets. The absence of

suitable long-term instruments to support capital formation is mirrored in a lack of short-term financial instruments to provide liquidity.

Considerable efforts have been made recently to address issues of regulation and supervision of Islamic financial institutions and, as a result, a solid regulatory framework for Islamic financial institutions is emerging. However, challenges remain, the most immediate of which can be classified into two groups: (i) financial engineering and (ii) operational.

In the former category is the challenge to introduce new *Shari'ah*-compatible products that enhance market liquidity, offer risk-management tools and enable greater diversification of portfolios. Applying financial engineering techniques to Islamic banking requires the commitment of resources to gain an understanding of the risk/return characteristics of each building block of the system and to offer new products with different risk/return profiles to meet the demands of investors, financial intermediaries, and entrepreneurs for liquidity and safety. The process of securitization to enhance marketability, negotiability, and return on assets is a prime candidate for financial engineering. With increased globalization, integration and linkages have become critical to the success of capital markets. Such integration becomes seamless and transparent when financial markets are able to offer a wide array of instruments. Financial engineering in Islamic finance needs to focus on the development of products that foster market integration and attract investors and entrepreneurs to the risk/return characteristics of the product, irrespective of whether it is Islamic or non-Islamic. Innovation is also needed to satisfy market demand for both short- and long-term maturity structures. Money markets that are *Shari'ah*-compatible do not exist at present and there is no equivalent of an Islamic interbank market where banks can place overnight funds, or where they can borrow to satisfy temporary liquidity needs.

Another operational difficulty facing Islamic finance is the current lack of an equity-based benchmark or reference rate (reflecting the rate of return in the real sector) for pricing assets and evaluating portfolio performance, or comparing various investment alternatives. In the absence of such a benchmark, a common—if questionable—practice has been to use the London Inter-Bank Offered Rate (LIBOR) as a proxy. While this may be sanctioned by *Shari'ah* scholars as a temporary expedient, the system would operate more efficiently if an index representing returns on profit/loss-sharing instruments were developed for use as a benchmark.

## ISLAMIC BANKING

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Islamic financial institutions have performed well during the high growth period of the industry but, with a rapidly changing global landscape, maintaining sustainable growth is just one of many challenges. So far, Islamic banks have capitalized on a fast-growing, demand-driven niche market but,

with a large number of existing Islamic banks and growing interest from conventional institutions (both Western and non-Western) tapping into this emerging market, the industry is becoming highly competitive. IFIs have been able to maintain a competitive advantage in a market which was characterized until recently by high entry barriers for conventional institutions which were less knowledgeable in *Shari'ah*. However, increased awareness and recognition of Islamic financial instruments, advances in technology, globalization and market integration, and more experienced and professionally advanced conventional institutions will create tough competition in the future. Some of the major challenges facing Islamic financial institutions are set out below.

### **Two-way Intermediation**

As impressive as the record of growth of individual Islamic banks may be, the fact is that these banks have served mostly as intermediaries between Muslim financial resources and major commercial banks in the West. In this context, this has been a one-way relationship. There is still no major Islamic bank that has developed methods of intermediating between Western financial resources and demand for them in Muslim countries. While there is considerable room for competition and expansion in this field, the long-term survival of individual Islamic banks will depend on how rapidly, aggressively, and effectively they can develop techniques and instruments that allow them to carry on a two-way intermediation function. They need to find methods of developing marketable *Shari'ah*-based instruments by which asset portfolios generated in Muslim countries can be marketed in the West, as well as marketing *Shari'ah*-based Western portfolios in Muslim communities.

### **Risk Management**

Financial markets are becoming more integrated and interdependent, thus increasing the probability of rapid contagion between them. Further, insufficient understanding of the new environment creates a greater risk perception even if the objective level of risk in the system is unchanged or reduced. The current wave of capital market liberalization and globalization may prompt the need for enhanced risk management measures, especially for the developing economies and the emerging Islamic financial markets. Whereas financial risk management is widely practiced in conventional financial markets, it is grossly underdeveloped in Islamic financial markets. IFIs need to take immediate steps to devise an infrastructure for implementing proper risk measurements, controls and management, and to produce instruments to share, transfer and mitigate financial risk so that entrepreneurs can concentrate on what they do best—manage exposure to business risk in which they have a competitive advantage.

This requires Islamic financial intermediaries to adopt appropriate risk management, not only for their own portfolio but to offer such services

to their clients. A financial institution which can offer guarantees, enhance liquidity, underwrite insurance against risks, and develop hedging tools for a fee, can and should be established. If the basic building blocks of the Islamic financial system are viewed as a set of “asset-backed” securities, derivatives can be created synthetically and can be used to share, transfer or mitigate financial risk. Both on- and off-balance-sheet hedging instruments should be developed using these building blocks by applying the techniques of financial engineering.

IFIs need to realize the importance of operational risk that arises from the failure of controls and processes. Currently, there is a serious lack of a risk-management culture and of enterprise-level sponsorship of active risk management. Formulating a strategy for risk management in Islamic financial markets will require a comprehensive and detailed discussion of the scope and role of derivatives within the *Shari’ah* framework; an expanded role for financial intermediaries with special emphasis on facilitating risk sharing; the application of *takaful* insurance against financial risk; and the use of financial engineering to develop synthetic derivatives and off-balance-sheet instruments.

### **Standardization**

Another operational challenge for Islamic banks is to standardize the process for introducing new products into the market. Currently, each Islamic bank has its own religious board to examine and evaluate each new product. Each religious board may have its preferences or adherence to a particular school of thought. This process needs to be streamlined and standardized to minimize time, effort and confusion. Some banks have already instituted a post-product audit process by audit committees to ensure compliance with the *Shari’ah* guidelines defined by the religious board. However, this needs to be applied across the industry as a whole.

### **Consolidation**

Given the large number of small institutions, Islamic banks do not enjoy economies of scale. Indeed, many banks use the facilities of conventional banks as intermediaries for treasury management, foreign exchange, portfolio services and investment banking, which reduces their profit margins. It is time, perhaps, for Islamic banks to seriously consider merging into large financial institutions in order to benefit from economies of scale and reduced overhead costs through efficiency gains.

### **Governance**

In principle, the governance model in the Islamic financial system—with its *Shari’ah* boards, public-policy institutions, regulatory and supervisory institutions to monitor the performance of IFIs, and its commitment to



contracts that protect the interests of all stakeholders—is similar to that of a stakeholder-based incentive system. The governance issues of IFIs are similar to those experienced in an “insider” system of governance, where the institutional investor plays an active role in the governance process.

While increased monitoring by investment account holders as a result of increased transparency is highly desirable, their representation in the organs of governance raises several operational and implementation concerns. As the majority of investment account holders are individuals, who may not organize themselves collectively to perform the necessary monitoring, this places greater responsibility on regulators and *Shari’ah* boards to ensure that an adequate monitoring mechanism is in place to protect their rights. As the custodian and manager of investment accounts, the financial institution itself becomes an institutional investor with a vested interest in the governance of the institutions with which it places funds. This issue is not generally highlighted in current discussions of corporate governance.

Finally, the role of the *Shari’ah* boards in providing sound governance is also critical. The current practice of each institution maintaining a *Shari’ah* board or adviser leads to inefficient decision-making arising from a duplication of effort and a lack of standardization. As discussed earlier, a system-wide *Shari’ah* board comprising religious scholars who are also trained in Islamic economic and financial principles would be more efficient and cost-effective.

This system could work closely with the regulators and supervisors to ensure that effective monitoring and supervisory controls are devised to protect the rights of all stakeholders with whom the financial institution has explicit or implicit contracts.

## ENDNOTES

1. Raghuram (2005).
2. Interestingly, in the same paper Mehra reported that one dollar invested in equity in 1802 would have been worth nearly \$560,000 in 1997, whereas the real worth of the same dollar invested in Treasury bills over the same period would have been \$276.
3. For further details, see Minsky (1982) and Khan (1987).

## CHAPTER 17

# Issues and Challenges

**A**s is invariably the case in any emerging market, the Islamic financial industry faces several challenges. The nature of these challenges is diverse, as there are numerous issues concerning its theoretical foundation, infrastructure development, systemic implementation, integration with external systems, and enhancing operational efficiency. There are challenges at both macro and at micro levels and the approach taken to these will determine the future success or failure of the industry. Although the industry has enjoyed handsome growth, its sustainability and future growth will largely depend on how successful it is in addressing these challenges. If due attention is not paid to addressing these issues, Islamic finance will fail to achieve its full potential and to deliver on its promise. Therefore, the stakes are very high and demand serious discussion of the issues.

There is no shortage of literature pointing out the deficits in the current state of the industry and what needs to be done. Table 17.1 summarizes some of the prescriptions given for enhancing different segments of the industry. The next logical step would be to prioritize the steps to be taken and then prepare an action plan. A complete coverage of all the issues and challenges would be a lengthy and voluminous academic exercise. However, in this chapter we attempt to provide a brief overview of some of the major challenges.

### **DEVELOPMENT OF THEORETICAL FOUNDATION**

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Conventional economics is the result of decades of rigorous theoretical and empirical research, debate and analytical argument and has gone through many iterations. This has led to solid and time-tested development of models that provide a foundation for further analytical work. This is evident in all aspects of economics, whether micro or macro issues or in fields such as economic development or international trade and finance. This collective understanding is evolving every day, and has become a valuable asset in understanding the economic behavior of individuals as well as of societies. Similar rigorous analytical work, especially in areas of core economics, is seriously lacking in the case of Islamic economics. The research in Islamic

**TABLE 17.1** Suggestions for enhancing the Islamic financial industry

Islamic Banking	Money, Capital Markets	Legal/Regulatory Issues	Others
Consolidation	Develop liquidity-enhancing mechanisms	Enhance and harmonize standards	Social sector financing. Institutionalization of Islam's redistributive instruments
Expand scope, services, products	Develop asset-linked, rather asset-based, products	Enhance corporate governance	Develop non-bank financial intermediation
Enhance risk management	Develop <i>sukuk</i> based on intangible assets such as services, rights, working capital, etc.	Enhance <i>Shari'ah</i> governance	Reputational risk
Lessen reliance on commodity/fixed-income-like products	Develop partnership and risk-sharing products	Supervision and monitoring	Financial engineering. Ease of product development
Reduce exposure to operational risk	Develop <i>Shari'ah</i> -compliant securities/stock markets	Financial Sector development	Hedging with or without derivatives
Liquidity-enhancing products	Develop Islamic benchmarks	Investor/creditor rights	Public finance
Hedging products	Public finance instruments	Insolvency laws	Monetary policy management

Source: Iqbal (2010)

finance has primarily been driven by business needs to establish an Islamic banking and financial system, and less attention has been paid to developing a comprehensive analytical framework based on Islamic economic principles. The progress in understanding and describing economic behavior as envisioned by Islam is slow and needs more attention. Without a solid foundation and rigorous analytical work, it would be difficult to present viable solutions to economic and social problems.

The development of a theoretical foundation of finance in Islam also needs attention. Several areas—such as asset pricing, corporate finance, derivatives, and hedging—require further research. For example, in the absence of a risk-free asset, how will the Capital Asset Pricing Model (CAPM) behave, or how will Black's zero-beta model behave with restrictions on short selling?<sup>1</sup> Several such issues have not been researched. In the development of conventional economics, finance was not seen as a separate field until relatively recently. In conventional economics the importance of investment has been long recognized. Financial markets were seen as important in attracting savings, and as a channel to allocate savings to investors and to do this in the most efficient way. The health of financial markets was appreciated largely in accommodating the financing of the real economy. The importance of finance was perceived from this very narrow perspective. Thus, earlier finance was not treated as an important and separate field of endeavor.

The appreciation of risk was a crucial building block in the development of modern conventional finance. Early in the twentieth century, Irving Fisher, one of the giants of economics, was the first to appreciate the importance of risk in the functioning of financial markets. In the 1930s a number of renowned economists, most notably Keynes, saw the importance of risk in the selection of a portfolio. But in their analysis and discussion, the role of risk was largely limited to affecting expected capital gains and speculative and hedging activities. This strain of analysis led to results covering the relationship of futures prices and expected spot prices (normal backwardation), the price-stabilizing effect of speculation, the impact of risk on assessing the value of future streams of income and, eventually, to the development of portfolio theory.

These developments in turn led to the realization that arbitrage was one of the two fundamental features of conventional finance; this is supported by the Black-Scholes-Merton option-pricing model and by the Modigliani-Miller Theorem. In the case of option pricing, if a portfolio of other assets can reproduce the return from an option, then the price of the option must be equal to the value of the portfolio; if not, there will be arbitrage opportunities. The Modigliani-Miller Theorem also uses arbitrage reasoning to examine the impact of corporate financial structures for arriving at a market value for a firm. If the production outlook of two firms (with differing financial structures) is the same, then the market value of the firms must be the same; if not, there is opportunity for arbitrage.

The second important development in the modern theory of finance was initiated by the empirical finding that commodities and asset prices behaved randomly. Paul Samuelson came up with an ingenious explanation for this observation that asset prices had to behave randomly; if this was not the case then arbitrageurs could exploit the opportunity to make a profit. For asset prices to behave randomly, all available and relevant information would have to be immediately translated into price changes in markets that behaved "efficiently." Thus the Efficient Market Hypothesis was born. In

sum, an appreciation of the importance of risk, arbitrage pricing, and efficient markets are the relatively recent foundations of conventional finance. At its core, conventional finance is seen today as the management of risks.

In Islam, the importance of risk is clearly acknowledged. While conventional finance, with its roots in economic theory, has developed instruments to identify and trade risk to those willing to assume it, in Islam risk cannot be sold in any manner. The study of finance in Islam is built on the foundation that risk must be *shared* between parties in any endeavor (as opposed to being assumed entirely by one party or the other). Finance in Islam can benefit from the same theoretical developments but with two important constraints: Islam prohibits the notion of a risk-free rate of interest; and instruments that partition risk contrary to Islamic teachings cannot be allowed. Finance can be developed in Islam along conventional lines but with these two important constraints. On the face of it, modern finance should provide practitioners of Islamic finance with added tools to achieve their central goal of better risk sharing. Moreover, as Islam prohibits financial gain without the assumption of some measure of risk it would appear that efficient markets and the random-walk behavior of financial assets and commodities are implicitly, if not explicitly, subsumed in Islamic teachings.

In short, for Islamic finance to make further progress it needs to devote resources and effort to develop analytical models and a theoretical foundation which distinguishes it from conventional economics and finance. Without this, there is a danger that it will be marginalized as a small subset of the conventional system.

## **DEVELOPMENT OF ECONOMIC INSTITUTIONS**

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The optimal functioning of an Islamic financial system (or indeed of any system) requires that underlying economic and legal institutions are in place. The Islamic economic system is a rules-based system governing property rights, contracts, the behavior of economic agents, and social capital in accordance with the teachings of Islam. As a result of several years of inactivity in developing such economic institutions, any effort to build a financial system to comply with partial aspects of Islam is bound to face difficulties and result in sub-optimal performance.

Fergusson (2006) undertook a detailed survey of the literature concerning the development of institutions and legal frameworks, and of their linkage with financial development. A condensed version of his main arguments and relevant empirical evidence is given in Table 17.2.

However, these economic institutions are notable for their absence in many, if not all, Muslim countries. In the Middle East and North Africa (MENA) region, for example, Abed and Davoodi (2003) found that the rates of economic growth since the 1970s were not only lower than those of developing countries as a whole, but were, on average, twice as volatile. They attribute this poor performance to several factors: high population

**TABLE 17.2** Importance of institutions and legal framework for financial systems

	Main Theoretical Arguments	Empirical Research
Institutions	<p>Better protection of creditor rights increases the breadth and depth of capital markets.</p> <p>Laws and their enforcement influence the extent to which insiders can expropriate outside investors who finance firms. Credibly pledging collateral reduces asymmetric information problems.</p>	<p>Shareholder and creditor-rights indices (for 49 countries with publicly traded companies) increase opportunities for external finance (La Porta <i>et al.</i> 1997a, 1998).</p> <p>Creditor rights and law enforcement are also positively correlated with bank development (Levine 1998, 1999), firms' ability to raise capital (Kumar <i>et al.</i> 2001; Beck <i>et al.</i> 2003), efficiency of equity markets (Morck <i>et al.</i> 2000), efficiency of capital re-allocation (Beck and Levine 2002; Wurgler 2000), corporate and bank valuations (Claessens <i>et al.</i> 2000, 2003; La Porta <i>et al.</i> 2000) and ability to fund faster-growing firms (Demirgüç-Kunt and Maksimovic 1998), and firms with less collateral (Claessens and Laeven 2003).</p> <p>Law enforcement and creditor protection also reduces credit cycles and currency and banking crises (Johnson <i>et al.</i> 2000; Galindo <i>et al.</i> 2001, 2004; Boucher 2004).</p>
Legal framework	<p>Alternative view: strict protection of creditor rights (e.g. right to repossess collateral) might be inefficient and may impede continuation of efficient projects. Pro-creditor rights reduce risk-taking incentives for entrepreneurs.</p> <p>Protection of creditors reduces their incentives to screen projects and to discourage investment by overconfident entrepreneurs.</p> <p>Legal framework and corporate governance: by shaping firms' incentives, a weak protection of creditor rights and weak law enforcement might encourage adoption of remedial rules, higher ownership concentration, and excessive reliance on tangible and liquid assets.</p>	<p>Extending La Porta <i>et al.</i>'s (2000) exercise by including additional macroeconomic controls, Padilla and Requejo (2000) find that, although an efficient judicial system improves the size and efficiency of the credit market, the effect of creditor protection is inconclusive. By extending the sample (15 additional developing countries), Galindo and Micco (2001) find that the positive effect of creditor protection does hold, even after controlling for macroeconomic variables.</p> <p>Countries with weak laws and enforcement tend to introduce remedial rules such as mandatory dividends and reserve requirements (La Porta <i>et al.</i> 1998), display more ownership concentration (Zingales 1994; La Porta <i>et al.</i> 1998; Claessens <i>et al.</i> 2000; Himmelberg <i>et al.</i> 2000; Roe 2000; Caprio <i>et al.</i> 2003; Dyck and Zingales 2004), and invest more in tangible assets (Claessens and Laeven 2003) and liquid assets (Pinkowitz <i>et al.</i> 2003).</p>
Other institutions (trust or social capital)	<p>Trust: increasing the perception that others will cooperate facilitates cooperation in large and impersonal markets.</p>	<p>Social capital and financial development are strongly connected in Italy, according to household data (Guiso <i>et al.</i> 2000). Beyond Italy (in a sample of 48 countries), trust is positively correlated with the size and activity of financial intermediaries, bank efficiency, and stock and bond market development (Calderón <i>et al.</i> 2001).</p>

Source: Fergusson (2006).

growth and low productivity; lagging political and institutional reforms; large and costly public sectors; inefficient and inequitable educational systems; underdeveloped financial markets; high trade restrictions; and inappropriate exchange rate policies.

Many of the ills that contributed to the region's poor growth performance could be treated with the legal and institutional developments prescribed by Islam. While there is as yet no great impetus for this process, a number of Muslim countries have recently implemented macroeconomic and structural reform policies and have adopted international best-practice standards and codes. This, together with an increase in oil revenues, has resulted in a marked improvement in the economic performance of these countries. The implementation of international best practice in the areas of transparency and accountability, the development of an independent judiciary and the reform of the legal system, and the development of the financial sector could increase investment, employment and income, and lead to a reduction in poverty.

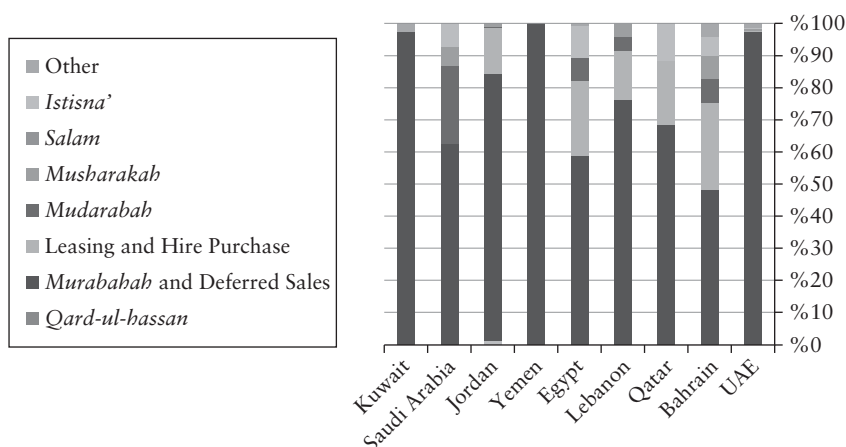
### **RELUCTANCE TO PROMOTE RISK SHARING**

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Risk sharing is the objective of Islamic finance. To foster the development of Islamic finance, there must be a sustained effort to remove the bias against equity finance; to reduce the transaction costs associated with participation in the stock market; to create a market-based incentive structure to minimize speculative behavior; and to develop long-term financing instruments and low-cost, efficient secondary markets for trading equity shares. These secondary markets would enable better distribution of risk and achieve reduced risk with expected payoffs in line with the overall stock market portfolio. Without true risk sharing, Islamic finance may provide a false impression of being all about developing debt-like, short-term, low-risk and highly liquid financing without manifesting the most important dimension of Islamic finance: its ability to facilitate high growth of employment and income with relatively low risk to individual investors and market participants.

In the long run, the Islamic financial system requires institutions that support risk sharing, partnership-based, equity-style financing and investment. The instruments they use will require close monitoring by the financial intermediary. To reduce the costs involved in this process, there will need to be mechanisms to perform collective monitoring of economic agents. Also, the trading of equity-based securities should be encouraged; this will be done in a stock market that operates according to *Shari'ah* principles, and thus prohibits the use of leverage (through margin accounts) and excessive speculation (including short sales).

One of the major criticisms of Islamic banks is their reluctance to hold risk sharing assets, despite the fact that Islam's economic principles demand that they should engage in partnerships and equity-sharing financial assets. For example, from Figure 17.1 it is evident that their first preference is for



**FIGURE 17.1** Asset composition of select Islamic banks by country, 2008  
Source: MENA Flagship Report (2010)

financing instruments that are generated through sale contracts and leasing instruments. Informal observation of more recent balance sheets shows a similar picture. The banks' heavy usage of sale-based financing has earned this practice the title of the "*murabahah* syndrome."<sup>2</sup>

The reluctance of Islamic banks to use risk-sharing instruments such as *musharakah* and *mudarabah* contracts is problematic for achieving the true potential and promise of the system. The reason for shying away from such instruments is a lack of appetite for risky assets, which is the result of trying to emulate conventional commercial banks, where the preservation of depositors' principal is the foremost objective. By investing in financing and trade-related instruments, Islamic banks are able to provide low-risk and safe investment opportunities. They should change this business model and expand their portfolio to include risk-sharing instruments. The banks often claim that their reluctance is a direct reflection of the reluctance of depositors for risk-sharing instruments. However, it is possible that the depositors' low appetite for such instruments arises from a lack of transparency and confidence in the ability of the financial intermediary. There is a lesson here that Islamic banks would do well to heed when it comes to selecting and monitoring risk sharing assets and enhance the transparency of the investment process by informing the depositors with good estimates of exposure to risks taken by the financial intermediary in investing in risk-sharing instruments.

## **FINANCIAL SYSTEM, ARCHITECTURE AND INFRASTRUCTURE**

There is well-documented research suggesting strong positive linkages between financial development and the economic development of the real sector of a country. In addition, the existence of a robust financial system



infrastructure leads to the development of financial markets and financial stability. The development of a robust financial sector is essential for any country, but the rapid growth of institutions offering *Shari'ah*-compliant financial products and services is posing challenges to the policymakers to develop a financial system supportive of such institutions. Other factors that will influence the design of such a system include continuing globalization, a growing emphasis on market discipline based on a regulatory environment, a shift towards a risk-focused supervisory approach, and increased competition from conventional financial institutions. The unique risk/reward characteristics of Islamic financial intermediation must also be incorporated into the design of financial architecture to promote a sound regulatory environment and to develop seamless integrations with the broader financial landscape.

The infrastructure of the financial system can be classified into three categories:

- *Systemic liquidity infrastructure*, which covers institutional arrangements for money and government securities markets, settlement systems, monetary and foreign exchange operations, and liquidity risk management
- *Information and governance infrastructure*, which includes accounting and disclosure standards and corporate governance arrangements for financial institutions
- *Insolvency regime and safety-net infrastructure*, which includes lender-of-last-resort arrangements, deposit insurance, and the legal framework governing bank insolvency, loan recovery, and creditors' rights.<sup>3</sup>

Financial architecture refers to the legal and institutional arrangements for a sound and well-functioning financial services industry. Financial infrastructure is a subset of the architecture and is often referred to as the underlying foundation to facilitate the preconditions for the functioning of the industry and the effectiveness of supervision and regulation of different segments.

At the national level, financial architecture includes legal and institutional arrangements for the regulation and supervision of the Islamic financial services industry. A robust legal infrastructure to define and enforce contracts, insolvency, and financial safety nets is essential. It should also include a framework for macro prudential surveillance, arrangements for efficient systemic liquidity, and a transparent and information-rich governance infrastructure.<sup>4</sup> At the international level, financial architecture improves coordination among various national policies and promotes financial and technical cooperation. This includes institutions such as the International Monetary Fund, the World Bank, the Bank for International Settlements, regional development banks such as the Asian Development Bank and Islamic Development Bank, international standards-setting institutions such as International Accounting Standards, and international

associations of market players for self-regulation and industry promotion such as the International Capital Markets Association.

Sundararajan (2006), Marston and Sundararajan (2006), and IDB/IFSB (2006) provide a detailed discussion of the issues and the missing elements in developing architecture and infrastructure for the Islamic financial industry, which we summarize below:

- While there are distinct differences in conventional and Islamic financial systems, significant elements of conventional infrastructure are equally applicable and accessible to Islamic finance. Therefore, there is no need to duplicate components of infrastructure that can be shared with some adjustments to accommodate specific operational requirements of Islamic finance.
- Financial architecture should be aligned with a vision for the industry, and it should start with a detailed policy designed to address issues of aligning financial sector laws—such as insolvency laws—with *Shari'ah* Law, strengthening the environment for risk sharing—that is, equity-based financial instruments and intermediation—and enhancing the corporate governance of institutions offering Islamic products and services.
- At the national level, the financial architecture for Islamic finance is exposed to the same weaknesses as the conventional financial sector in many developing countries. Inadequate or non-existent legal frameworks for regulation, weak observance of core principles (such as a lack of independence, weak risk management, weaknesses in disclosure), and ill-defined consolidated supervision affect both conventional and Islamic banks. In addition, there is a need for special treatment of the legal and institutional framework for the insolvency regime, investor rights, creditor rights, securitization and judicial enforcement.
- As part of the systemic liquidity infrastructure, the micro-structure of money and exchange and securities markets, payment settlement systems, and monetary and debt management operations are not yet well adapted to accommodate and integrate Islamic financial institutions into the broader financial system. These factors limit the development of securities markets, which is critical for promoting product innovations, risk management and effective supervision of Islamic finance generally. *Shari'ah*-compatible money and capital markets are essential for the implementation of monetary and fiscal policies.
- There is a need for strengthening the international architecture of Islamic finance, as there are still gaps and overlaps in the support structure provided by international infrastructure institutions. These institutions can and should, therefore, play a key catalytic role in promoting the industry at the national level. In this respect, the IFSB is expected to play the leading role in setting standards and to coordinate with the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), and the International Accounting Standards Board (IASB). The AAOIFI should continue to realign work

programs and promote greater adoption of its standards at the national level. The IIFM should focus on market practices and contract standards and strengthen its role as an association of market players. The LMC can play a role in promoting national and regional strategy for money-market development. The IIRA can play an important role in enhancing disclosure and transparency.

Compared with the conventional system, the current form of Islamic finance offers very limited functionality. Table 17.3 provides a functional assessment of Islamic financial markets as they exist today.

The design of financial infrastructure and architecture to promote Islamic finance is a challenge and demands serious commitment from stakeholders. Some of these challenges are discussed below.

**TABLE 17.3** Functional assessments of Islamic financial markets

Function	Assessment
Capital mobilization	Limited set of instruments; concentration in short-term maturities; low depth and breadth of markets; and lack of liquidity.
Managing risk	No derivative markets or organized mechanism for risk mitigation. High geographic and sector concentration. Limited diversification opportunities.
Pooling and diverse ownership	No or limited stock markets in Islamic countries. Where they do exist, they are illiquid and poorly supervised, offering limited opportunities for the pooling and diversity of ownership. In non-Islamic countries, limited <i>Shari'ah</i> -compliant stocks available to Islamic investors.
Efficient contracting	Lack of civil and commercial law based on Islamic law in several Islamic countries where the legal system is predominantly conventional limits efficient contracting. In non-Islamic countries, it may not be possible to replicate <i>Shari'ah</i> law in its intended form, which hinders efficient contracting.
Transparency and price discovery	Illiquid, shallow, and poorly supervised capital markets inhibit the process of price discovery and limit opportunities for arbitrage.
Governance and control	Not all stakeholders participate in the governance of financial institutions offering Islamic financial services. Lack of transparency in governance of <i>Shari'ah</i> boards.
Operational efficiency	High perception of operational risk resulting from a lack of proper accounting standards, clearing and settlement processes, and training personnel.

Source: Adapted for Islamic financial markets based on Ul-Haque (2002).

## Liquidity

Financial market efficiency and resilience are determined by the depth (indicated by the volume and frequency of transactions) and breadth (measured by the array of financial instruments and services available) of the market. Islamic financial markets are still small when compared to conventional markets. A large share of Islamic financial markets is dominated by commercial banking activities, but even this is still less than one percent of total conventional banking. Although there is growth in other areas of finance, such as capital markets and insurance, these are also very small. For example, the total size of outstanding *sukuk* as of 2007 was US\$140 billion, which was only 0.47 percent of a total outstanding debt of US\$29,728 billion in US markets.<sup>5</sup>

## Integration with Global Financial Landscape

Increasing globalization has spread Islamic finance to many different geographical locations where the infrastructure does not support Islamic finance-friendly institutions. This poses a problem for policymakers and regulators and can create an obstacle to the growth of Islamic finance. For Islamic finance to integrate well with the conventional system there is a need to develop international institutions and standard-setting agencies that can provide the necessary support to local authorities and develop procedures and standards which can be adopted with ease.

## Liquidity Risk and Lender of Last Resort

Several studies have highlighted the issue of liquidity risk associated with Islamic financial instruments and the resulting exposure to Islamic banks.<sup>6</sup> In addition, the lack of a lender-of-last-resort facility based on Islamic instruments further complicates the problem of liquidity risk. Although this facility is usually available to Islamic banks, such arrangements are based on interest—a prohibited element. For a fully functional financial system, a lender of last resort that complies with Islamic Law is another essential requirement. Very limited work has been done in this area and further research is required.<sup>7</sup>

## Development of Benchmarks

The practice of measuring the performance of an asset by comparing its return and risk to a well-defined benchmark is now standard in a market-centered financial system. Markets are good at offering an efficient, measurable, and consistent benchmark for different asset classes and securities. The dearth of transparent benchmarks that can be used to compare risk-adjusted returns complicates the task of evaluating the efficiency of financial institutions. Such benchmarks are valuable tools for measuring the relative

performance of different asset classes and, ultimately, the performance of the financial intermediary. The economic system in Islam suggests the use of return in the real sector as a benchmark for the return in the financial sector. However, the current practice of using interest-based benchmarks such as the LIBOR is certainly in direct conflict with Islamic principles. Although this practice has been accepted on an ad hoc basis under the law of necessity and in the absence of better benchmarks, several researchers have correctly raised the need to develop benchmarks that reflect Islamic modes of finance.

### **LIMITED MARKET-BASED FINANCIAL INTERMEDIATION**

Banks and financial markets play complementary roles. More transactions are now done in markets and by institutions that have an arm's-length relationship with their clients. This has not, however, marginalized traditional institutions such as banks and their relationships. The changes have allowed such institutions to focus on their core business of intermediation, customization, and financial innovation, as well as risk management. Financial institutions are able to perform their core functionality more efficiently if there are supporting markets to provide liquidity, risk transfer, and insurance. As the "plain vanilla" transaction becomes more liquid and amenable to being transacted in the market, banks wishing to be competitive will embrace more illiquid transactions.<sup>8</sup>

Institutions specializing in *Shari'ah*-compliant products have been operating on the same business model for some time and without much innovation. Given the lack of supporting money, capital, and derivative markets, financial intermediations are retaining excessive exposure, especially to liquidity risk, and are missing out on opportunities to diversify. For the Islamic financial system to function properly, financial intermediaries will need to specialize in mobilizing deposits, identifying investment opportunities, originating, structuring, and packaging securities, and managing risks, while allowing the complementary financial and capital markets to fill the remaining gaps and provide liquidity and risk sharing.

Allen and Gale (2007) suggest that a successful, deep, and active stock market requires that information, enforcement, and governance costs are eliminated or at least minimized. Once this happens, the cost of entry into the equity market is lowered and "there is full participation in the market. All investors enter the market, the average amount of liquidity in the market is high, and asset prices are not excessively high" (p.115). As mentioned earlier, where Islamic rules of market behavior are in place, the informational problems, transaction costs, and governance and enforcement issues would be non-existent or at such low levels that there would be little or no deterrence to entering the stock market.

There is, however, a gap between what Islam teaches and actual market behavior. For this reason, the actions governments take and the institutions

they create to remedy this behavior and to reduce the cost of market participation have to be stronger and more comprehensive than they are today if they are to replicate the behavior expected of market participants who act in compliance with Islamic rules. Such actions, policies and institutions would include:

- i. Enabling equities to compete fairly with debt-based instruments; this means removing all legal, administrative, economic, financial and regulatory biases that favor debt and place equity holding at a disadvantage
- ii. Creating positive incentives for risk sharing via the stock market
- iii. Investing in a massive campaign to educate the public on the benefits of stock market participation (the kind of campaign that the Thatcher Government ran in the UK, which increased stock market participation substantially in a short span of time)
- iv. Investing in human capital to produce competent, well-educated and trained intermediaries—lawyers, accountants, financial journalists and *Shari'ah* scholars—which would entail creating world-class business and law schools
- v. Limiting the leverage (including margin operations) of non-bank financial institutions and the credit-creation ability of banks through prudential rules that effectively cap the total credit the banking system can create
- vi. Developing a strong, dynamic regulatory and supervisory system for the stock exchanges to continuously monitor the behavior of markets and participants while staying a few steps ahead of those with a penchant and motivation to use regulatory arbitrage to get around rules and regulations
- vii. Finding ways and means of regulating and supervising intermediaries or, at least, mandating that they become self-regulating in order to minimize false reporting or misreporting
- viii. Ensuring transparent and accurate reporting of the day's trade by all exchanges
- ix. Establishing legal requirements for the protection of the rights of minority shareholders.

While this list is by no means exhaustive, implementing its recommendations will help reduce the cost of market participation, invest the market with greater credibility, and reduce reliance on debt financing. Black (2001) asserts that enshrining the legal protection of minority shareholders' rights alone would give countries large stock market capitalization, larger minority shareholder participation, more publically listed firms relative to the total population, less concentrated ownership, higher dividend payouts and lower costs of capital. Black also believes the potential for developing a vibrant stock market is greatly increased if minority shareholders can be assured of receiving good information concerning the true value of

businesses in which the listing companies are engaged, and that there is sufficient legal, regulatory and supervisory protection against such things as insider-trading transactions.

Where these things are lacking, the problems of moral hazard and adverse selection raise their ugly heads. Having enforceable laws and credible institutions in place can serve to assure investors of the honesty of publicly listed firms and of the full transparency and accuracy of their reporting and information. These laws governing financial disclosure and securities, for example, would be backed up by strong sanctions for anyone tempted to defraud investors through false or misleading information. Sanctions imposing risk of liability (to investors) on accountants, lawyers, traders or investment bankers in retaliation for false reporting, fraudulent, misleading information or faulty endorsements can be powerful tools for dissuading all concerned from defrauding investors. Requiring intermediaries to be licensed—with the attendant threat that licenses can be revoked—is another powerful regulatory tool, particularly when this is backed by the additional threat of heavy fines or criminal proceedings for abusing the system. Stock exchanges, too, have a critical role to play through implementing and enforcing stringent listing standards, again backed by the threat of heavy fines or the delisting of companies that violate disclosure rules. An active, dynamic, well-informed financial press can be valuable in creating a culture of disclosure, which would be closely monitored by a strong, independent regulatory agency.

While the above policies and institutions are crucial in reducing the cost of participation in stock markets and thus promoting widespread risk sharing, governments need to do more: they must lead by example. They could become active in markets for risk sharing. Generally, governments do share risks with their people through, for example, their tax and social expenditure policies. They are silent partners. They share the risks of the financial system through monetary policy and deposit guarantees. They could choose to finance part of their budget, at least their development spending, through risk sharing and direct ownership of development projects with their citizens. In this way, they would reduce the debt burden on the budget. This reduction in government borrowing reduces the burden on monetary policy as well. Governments undertake public-goods projects because the characteristics of these goods—indivisibility and non-exclusivity—prohibit their production by the private sector and therefore are undertaken by governments. However, their social rate of return is substantial and much higher than private rates of return. A recent popular proposal suggests that these projects should be undertaken jointly with the private sector, hence the “public–private partnership” (PPP) label. However, this proposal has a number of problems—market distortion, and informational and governance problems being just three.

## **EXPANDING SCOPE OF FINANCIAL INTERMEDIATION**

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A financial intermediary transforms savings into investment and, in the process, creates additional value by reducing search, monitoring, and transaction costs, as well as diversifying and/or hedging risks, thereby allowing more efficient utilization of resources. A financial intermediary performs these functions through the design and utilization of instruments or products intended to achieve a specific objective. The nature of financial intermediation in Islamic finance is distinct from conventional finance in several ways, the most critical being that a financial intermediary in the Islamic system plays multiple roles. Whereas organized markets—such as money, capital, and derivative markets—complement the role of a conventional financial intermediary, in the Islamic system an intermediary is expected to undertake some of these functions. In other words, an Islamic financial system has more common features with “bank-centered” financial systems such as those of Japan and Germany than with the “market-centered” systems of the US and the UK (Iqbal 2005; Iqbal and Mirakhor 2007).

At present, financial intermediation in Islamic markets is very restricted. It is limited mainly to commercial banking activities, with the gradual introduction of investment banking services. Within commercial banking, there is more emphasis on trade financing and some leasing-based assets that are of short-term maturity and often illiquid. In the case of investment banking, the menu of products and services is even more limited and is often targeted at high-net-worth individuals.

IFIs have to expand the scope of their activities to provide a wider range of products and services in the areas of corporate finance, risk management, SME financing, and wealth management. Research has shown that during early phases of development where capital markets are not well developed, financial intermediaries play a critical role in providing financial services to the corporate sector. In the absence of liquid Islamic capital markets, they will have to become the main source of financing. Furthermore, the simple availability of financing will not serve this purpose; the mode of the service will have to be improved. The financing would have to be cost-effective, flexible, and client-oriented. Financial intermediaries must understand the needs of corporate sector clients to develop customized solutions that can make them competitive in the market.

Major structural changes in the role of financial intermediaries are required in the area of risk management. Their role in developing a risk management infrastructure should be twofold: first, to develop and apply risk management techniques for their own portfolios; and, second, to offer risk management services to their clients. Risk management tools expand the role of a financial intermediary that can offer innovative products and risk management services to the client, and can also manage its own exposure more efficiently and in a cost-effective manner. Managing financial risk also creates profitable opportunities for financial intermediaries in several



ways. For example, a bank's risk experts are likely to provide more effective advice to clients and more effectively differentiate their products. The fees associated with supplying risk management transactions can be an important source of revenue, and since these transactions increase customers' profits by lowering the probability of financial distress, they also indirectly lower the intermediary's loss exposure.<sup>9</sup>

Consumer and retail banking is another area where there are gaps. The question is often raised about the potential for developing financing instruments that are not based on a tangible asset; for example, an instrument to provide financial assistance for student loans. Education loans do not create any tangible asset and do not have any collateral other than personal guarantees. Another case is the area of consumer services, such as credit cards. An original purchase on a credit card may not conflict with *Shari'ah* principles, but once it becomes an interest-bearing loan, the same transaction is in conflict. In such cases, it becomes incumbent on IFIs to find workable solutions. If they are unable to supply a complete set of services, consumers wishing to comply with *Shari'ah* will be at a disadvantage.

Another area requiring attention is financial products and services for small and medium-size enterprises (SME). A vibrant SME sector plays a critical role in the economic development of any country. Proponents of Islamic finance advocate that Islamic finance encourages entrepreneurship and is friendly to grassroots entrepreneurship. However, in reality, the majority of IFIs do not have any systematic program to promote SMEs. This will be discussed further later in the chapter.

Advances in information technology and financial engineering have obviated the need for "bricks and mortar" banking and financial markets. As Bill Gates once remarked, "banking is essential, banks are not." Now, consumer and mortgage financing, corporate credit, all depository asset management, and investment banking services—which not long ago would have required considerable investment in physical infrastructure—are offered by means of global e-commerce trading systems that can easily accommodate different languages across borders. Importantly, these systems are defined by their product rather than by their geographical location. Islamic financial institutions are scattered over different geographical regions and, therefore, are overexposed to credit and market risk in domestic markets and regions. The availability of services through the internet will expand their client base and will help them diversify their portfolios.

Although Islamic banks have grown in number, the average size of their assets is still small by comparison with conventional banks. The majority of Islamic banks are below the benchmark asset size of US\$500 million considered to be the minimum for an efficient conventional bank. In Table 17.4 we listed the top 10 Islamic banks. As of 2010 Top Islamic Banks' asset size is only 1.5 percent of top conventional bank in the World and only 26 percent of conventional bank ranked number 100 in the world. Whereas as of early 2000, there was no Islamic bank in the list of top 500 world banks, at least one Islamic bank, as of 2010, was included in the list of top 1,000 banks

**TABLE 17.4** Top Islamic Banks and Islamic Windows as of 2010

Name		Country	<i>Shari'ah</i> Compliant Assets (\$m)	Return on Assets (RoA)
<b>Islamic Banks</b>				
1	Al-Rajhi Bank	Saudi Arabia	45,528	4.03
2	Kuwait Finance House	Kuwait	40,318	0.27
3	Dubai Islamic Bank	U.A.E.	22,835	0.59
4	Abu Dhabi Islamic Bank	U.A.E.	18,620	0.94
5	HSBC Amanah (Global)	U.K.	16,700	n/a
6	Bank Rakayat	Malaysia	14,785	3.36
7	Al Baraka Banking Group	Bahrain	13,623	0.99
8	Maybank Islamic Berhad	Malaysia	12,402	1.02
9	Qatar Islamic Bank	Qatar	10,789	4.93
10	Bank Islam Malaysia Berhad	Malaysia	9,268	0.27
<b>Islamic Windows</b>				
1	National Commercial Bank (Jeddah)	Saudi Arabia	17,113	1.72
2	Riyadh Bank	Saudi Arabia	11,913	1.8
3	Saudi British Bank	Saudi Arabia	11,198	n/a
4	Arab National Bank	Saudi Arabia	8,507	2.05
5	Banque Saudddi Fransi	Saudi Arabia	8,125	2.00

Source: Banker (2010)—This list excludes banks based in Islamic Republic of Iran. *The Banker*, Top 500 Islamic Financial Institutions, The Banker, Special Supplement, Nov. 2010, p. 34.

<http://www.thebanker.com/Banker-Data/Banker-Rankings/Top-500-Islamic-Financial-Institutions>

in the world as compiled by *Banker* (2010). Ranking of Al-Rajhi Bank, Kuwait Finance House, and Dubai Islamic Bank Ranks were 242, 270, and 383 respectively. Large institutions have significant potential for efficiency gains from economies of scale and scope, organizational efficiency, and a lower cost of funding. Given their size, Islamic banks are unable to reap these benefits.<sup>10</sup>

In the absence of debt and derivatives markets and in light of the underdevelopment of equities markets, financial intermediaries will be required to take up the slack. In the changing global financial landscape, Islamic banks will have to go beyond their traditional role as commercial banks and develop areas such as securities, risk management, retail banking, asset management, and insurance that are currently absent or inadequate.

The nature of financial intermediation and the style of financial products and services offered make Islamic banks a hybrid between commercial and investment banking, similar to a universal bank. A universal bank benefits from economies of scope because of its close relationship with an established client base and the access this provides to private information. Combining different product lines (such as banking and insurance products) or commercial and investment banking lines may increase the relationship value of banking at a much lower average cost of marketing.

For example, by expanding the scope of their services, Islamic banks could spread the fixed costs (both physical and human capital) of managing a client relationship over a wider set of products, leading to a more efficient use of resources. They could use their branch networks and other channels to distribute additional products at low marginal costs. As universal banks, they would be able to capitalize on their good reputation established in one product or service area to market other products and services with relatively little effort. This would also benefit consumers by enabling them to purchase a bundle of financial services from a single provider, rather than having to expend time and money acquiring them from different providers.

## **WEALTH MANAGEMENT**

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Wealth management entails offering financial planning and management to high-net-worth individuals and private and public institutions, with the goal of sustaining long-term wealth. With the current wave of petro-dollars being earned by GCC countries, the demand for such services from public-sector institutions is bound to increase. Although several GCC countries are currently using conventional investment vehicles, the increasing demand for *Shari'ah*-compatible products is likely to mean that some portions of this wealth may be available for Islamic financial markets. Similarly, there are increasing numbers of institutional investors who will be interested in *Shari'ah*-compatible wealth management. These include central banks with excess foreign-exchange reserves, state pension funds, future funds (such as the oil funds established by some countries), and sovereign wealth managers.

Several prominent economists have argued that the foreign-exchange reserves held by the central banks, and some sovereign wealth funds should consider investing a portion of these reserves in riskier assets such as the equity markets. This should be encouraging for Islamic finance, which is based on the principle of risk sharing and is friendly to equity sharing investments.

However, offering robust wealth management in Islamic finance presents serious challenges. Any wealth management process begins with defining investment objectives and goals. This is followed by a rigorous strategic asset-allocation (SAA) process which determines the optimal mix of asset classes to achieve the desired goals and objectives. In conventional finance, the SAA process has become a science, with the aid of sophisticated

statistical and quantitative models. The analysis is well supported by considerable historical data for each asset class to assist in understanding past behavior and to forecast future performance. Such models are driven by comparable benchmarks, arbitrage-free strategies, hedging mechanisms, and—most importantly—reference points for returns for different maturity structures in the debt market. With these tools, the SAA process helps in constructing an optimal portfolio of different asset classes to achieve target investment objectives at acceptable levels of risk.

Constructing a meaningful SAA framework in Islamic finance is a challenge. First, a fixed-income debt market—other than the limited and illiquid *sukuk* market—does not exist. Therefore, the SAA framework would have to resort to using proxies from conventional debt markets, which may not be an ideal situation. Second, there are no *Shari'ah*-compliant benchmarks against which an SAA strategy can be devised. Although a number of such benchmarks are available in the equity asset class, they have yet to be developed for fixed-income markets. Third, given the prohibition of interest, and thus of pure debt security, an SAA framework would have to work with other asset classes with distinct risk/return profiles. For example, it would require the development of *mudarabah* arrangements where the manager can deploy funds in a customized fashion, which are hard to model. The highly customized nature of financial assets adds to the complexity of modeling.

All of these factors mean that the SAA framework will require a more complex design and therefore extensive quantitative modeling. In the absence of a meaningful SAA framework, the investor will be exposed to unknown risks and, as a result of potentially inappropriate asset allocations, may not be successful in achieving long-term goals.

## **RISK MANAGEMENT FRAMEWORK**

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Given their limited resources, Islamic banks are often unable to afford high-cost management information systems or the technology to assess and monitor risk in a timely fashion, which means that their risk exposure is high. IFIs need to adopt appropriate risk management, not only for their own portfolio but for that of their clients. Diversification and risk management are closely associated with the degree of market incompleteness. In highly incomplete markets, financial intermediaries are in a better position to provide diversification and risk management than the investors for whom they act.

Exposure can also be reduced by working closely with clients to reduce their exposure, which will ultimately reduce the intermediary's exposure. In other words, if the debtor of the bank has lower financial risk, this will result in better quality credit for the bank. Furthermore, monitoring becomes vital in cases where Islamic banks invest in equity-based instruments because an institution with limited resources may not be equipped to

conduct thorough monitoring. An institution with adequate resources may develop processes, systems, and training to undertake effective monitoring. There is clearly a need for Islamic financial institutions that can offer guarantees, enhance liquidity, underwrite insurance against risks, and develop hedging tools for a fee.

## **REGULATORY AND GOVERNANCE ISSUES**

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Several studies have identified weaknesses and vulnerabilities among Islamic banks in the areas of risk management and governance.<sup>11</sup> Operational risk, which arises from the failure of systems, processes, and procedures, is one area of concern. Weak internal control processes may present operational risks and expose an Islamic bank to potential losses. Governance issues are equally important for Islamic banks, investors, regulators, and other stakeholders. As we saw in earlier chapters, the role of *Shari'ah* boards brings unique challenges to the governance of Islamic financial institutions. Similarly, human resource issues, such as the quality of management, technical expertise, and professionalism, are also the subject of considerable debate.

Implementing a risk management framework requires close collaboration between the management of IFIs, regulators and supervisors. At the institutional level, implementation is the responsibility of management, which should identify clear objectives and strategies and establish internal systems for identifying, measuring, monitoring, and managing various risk exposures. Although the general principles of risk management are the same for conventional and Islamic financial institutions, there are specific challenges in the management of risk in Islamic financial institutions.

Corporate governance in Islamic finance entails implementation of a rules-based incentive system that preserves social justice and order among all members of society. Governance processes and structures inside and outside the firm are needed to protect the ethical and pecuniary interests of shareholders and stakeholders. Iqbal and Mirakhor (2002) present a stakeholder-centered model of corporate governance based on the principles of Islam and suggest that an institution operating within an Islamic system is expected to protect the rights of all stakeholders in the firm as well as in the society. At the operational level, there are serious issues relating to the rights of investment account holders (IAHs)—that is, the depositors—as their participation in the governance structure is non-existent. Similarly, Islamic banks maintain several reserves to smooth income and to compensate IAHs in times when actual profits are below market expectations. However, there are no clear rules relating to the governance of such reserves.

Implementation of financial disclosure is another priority. Ideally, jurisdictions within which Islamic banks operate should implement accounting and reporting practices in line with accepted international standards. This could be accomplished by adopting the official AAOIFI standards, using

them as a basis for national standards, or integrating them into existing accounting and auditing standards. AAOIFI standards ensure that only the best accounting and auditing practices are used. They allow comparability across Islamic banks in different jurisdictions, although they may limit comparability between Islamic and conventional banks. Stakeholders involved in Islamic finance will find it easier to gain familiarity with a single accounting framework, rather than having to deal with multiple national standards. Simply extending International Financial Reporting Standards (IFRS) or national conventional standards is not likely to bring the same clarity, because it may not allow the disclosure of relevant information.

Poor corporate governance imposes heavy costs, but the mere extension of international standards to Islamic banks may not be sufficient to combat this. The principles and practices of Islamic financial services require a thorough review: sound corporate governance requires the formulation of principles and enforcement (for more, see van Greuning and Iqbal 2007). In many countries where Islamic finance is developing, regulators often lack the power to enforce rules, private actors are non-existent, and courts are “underfinanced, unmotivated, unclear as to how the law applies, unfamiliar with economic issues, or even corrupt” (Fremond and Capaul 2002). Furthermore, a “law habit” culture—that is, a propensity to abide by the law—must be rooted in society. While the ability to enforce regulations is inextricably coupled with the overall process of development, legislation enabling transparency, private monitoring initiatives, and investments in the rule of law by willing authorities can pave the way to the emergence of regulatory frameworks.

The regulation of Islamic financial institutions is one area in which there have been substantial developments in recent years and the progress in this respect is worth appreciating. Credit for this goes to the collective efforts in setting up such organizations as the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB), with the help of multilaterals such as the IMF and Islamic Development Bank (IDB). In its short life, the IFSB has made a noticeable mark on international financial circles in promoting Islamic finance and developing standards and regulatory frameworks. If this trend continues, there is reason for optimism about the further globalization of Islamic finance. However, more work needs to be done.

Whereas the current financial crisis has highlighted vulnerabilities in financial systems, it has also recognized new challenges facing the regulation of cross-border and highly integrated financial markets. Prior to the crisis, the emphasis was on market discipline and on promoting standardization and harmonization of rules and practices. International financial intermediation was subject to a growing set of standards and codes, such as the Basel Core Principles on Banking Supervision, transparency and monetary management guidelines, IOSCO capital markets standards, corporate-governance rules, anti-money laundering (AML), and combatting the financing of terrorism (CFT). The objective was to enhance the efficiency of

the system by delivering the best services at the lowest cost to the consumer. However, the financial crisis has exposed the need to strengthen the stability of the system, which has led to a consensus on the need for more regulation.

The current situation offers both opportunities and challenges for the Islamic financial industry. Industry stakeholders can influence policy formulation at early stages to ensure that the new regulatory environment is more “friendly” to Islamic finance and addresses some of the key issues in regulating IFIs. These issues include the treatment of IAHs as stakeholders, enhancing transparency in financial disclosure, and standardization. This will require active participation in the debate and the formulation of the new regulatory environment at local and international forums.

The real challenge will be the enforceability of new rules and standards. Currently, IFIs operate for the most part in dual-system set-ups, which impose additional responsibilities on the regulators to maintain regulatory and supervisory standards for both conventional and Islamic institutions. This practice is both resource-intensive and expensive. With stricter standards, the challenge will be to ensure that Islamic financial institutions receive due attention and priority in this process. At present, regulatory and supervisory standards, including compliance with Basel II, are being developed for IFIs, though their enforceability is in question. Since the majority of IFIs operate in developing economies, it requires extra effort to enforce the standards irrespective of how good the standards may be.

Islamic financial institutions are perceived to have higher exposure to operational risk because of the lack of proper risk systems and trained staff. In the new financial environment, there will be more reliance on risk monitoring and management. New techniques for monitoring credit and liquidity risk will be introduced and old techniques such as VaR will be refined to reflect better exposures. IFIs should start addressing this issue by updating their risk systems. At the same time, regulatory bodies should ensure proper training for their staff as well as for financial institutions. Regulators and supervisors should also develop a better understanding of certain practices of the financial institutions in assessing and monitoring risks.

### **Going Beyond Banking**

The distinction between traditional commercial banking and investment banking is becoming blurred, and there is a global trend to mix financial services with non-banking services. Although this trend is prevalent in major industrial economies, it has not been embraced by many of the emerging markets where Islamic finance is practiced. For example, an IMF study in 2003 ranked several countries in the Middle East according to their level of financial development and found that countries throughout the region had a weak institutional environment and a poorly developed non-bank financial sector.<sup>12</sup> There has not been much progress since then. Islamic finance has been dominated by commercial banking, and the amount of investment banking, insurance, asset management, SME financing, and microfinance is very small.

Islamic finance that claims to promote social justice and advocates equal opportunity for less-fortunate segments of society needs to develop an SME and microfinance industry. A well-developed microfinance industry will promote economic development in underdeveloped Islamic countries. As poor segments of society become economically empowered, they will expand the base of depositors and investors. While microfinance institutions have been successful in conventional markets, there are only a few cases of such institutions operating on Islamic finance principles. Their phenomenal success within conventional finance has forced even private investors to regard microfinance as a potential and viable asset class. In an Islamic system, instruments such as *qard-ul-hassan*, *sadaqat*, and *zakah* can play a vital role in serving the poor, and the role each instrument can play needs to be reviewed.

The emergence of Islamic finance in modern times began with non-bank financial institutions such as Tabung Haji in Malaysia, and Mitghamr and Nasser Social Bank in Egypt. The objective of these institutions was to fill the gap left by conventional banking institutions. Research over the last couple of decades shows how significant are the contributions of non-bank financial institutions that complement the activities of banks by providing various services to different segments of the economy. Research also documents the diversification benefits of non-bank financial institutions, adding to the stability of the financial services.

Conventional non-banking financial institutions have grown to cover a wide range of activities such as private equity, joint venture, credit unions, advisory services, and specialized finance houses. In addition, specialized forms of financing are in practice as well, including trust finance, endowment funds, and cooperatives. Such institutions have special relevance to Islamic finance. For example, today's trust financing or endowment funds have their roots in the Islamic institution of *waqf* (endowments), which has made enormous contributions to the economic development of Muslim societies throughout their history. In addition, the Islamic system offers unique instruments which do not have any direct points of comparison in conventional finance. *Qard-ul-hassan* (interest-free loans), for instance, have proved to be effective in promoting economic development and a means of alleviating poverty.

The objectives of socioeconomic justice and the equitable distribution of wealth separate Islamic economic principles from others. As we have seen, the *Qur'an* places great emphasis on the redistribution of income and wealth, and mandates institutions for this purpose. The most important of these are the institutions of inheritance—*sadaqat*, *zakah*, *waqf* and *qard-ul-hassan*, which all have wide-ranging implications for economic development and are necessary for the welfare of society. These instruments are vehicles for ensuring just conduct and maintaining a healthy level of wealth distribution. A major reason for the inadequate levels of economic growth and the existence of widespread poverty in many Muslim societies is non-compliance with the rules of just conduct in the economic sphere. It is also



clear that this state of affairs, in turn, stems from a general lack of familiarity with these rules among Muslims.

In an Islamic economic system, various levies are imposed on production or income to redeem property rights accrued by different members of the society. It is important to realize that in no way are these levies to be considered as charity, a common misunderstanding among laymen and scholars alike.

According to some estimates, the assets of the non-bank financial sector will make up around 8–10 percent of total Islamic assets.<sup>13</sup> Given the size of the Muslim population and the GDP of Islamic countries, this estimate appears to be on the low side. Actual potential is much more, as these institutions have to be expanded to cover wider segments of society.

The following steps are suggested to strengthen this sector:

- Develop institutions to formalize the implementation of redistributive instruments of Islam. Formal institutions to channel these flows in the most effective fashion need to be developed. These could be dedicated institutions specializing in the distribution of funds in the most cost-effective and most beneficial manner. If there are well-functioning Islamic financial intermediaries, these can become a distribution channel for these social welfare services as part of their customer services. A reputation of positive contributions to social welfare could serve as an asset for the institution in attracting or retaining customers.
- Develop a legal framework to encourage and protect non-banking financial institutions to enable them to operate in a friendly environment.
- Design and implement a prudent regulatory and policy framework for a broad-based and efficient non-bank financial sector. Some regulatory overview may also be needed to instill confidence and protect stakeholders and to ensure the healthy growth of the industry. Furthermore, tax neutrality can play an important role in further growth of this sector.<sup>14</sup>

### **Promotion of SME Financing**

The Islamic financial industry and policymakers should develop ways to promote SMEs and their access to the formal financial sector. In developing appropriate products, *mudarabah* contracts based on principal/agent principles would be well suited for the purpose. However, this type of contract has yet to be institutionalized in most Muslim countries. While conventional banks are constrained by their conservative approach to risky assets and by protective regulatory regimes from extending credit to SMEs, this need not be the case for Islamic banks, which can hold *mudarabah*-based assets with no regulatory constraints. Furthermore, IFIs are encouraged to enter into equity partnerships, which can be used to promote the SME sector. These

instruments should be developed through the banking or non-banking sectors to promote SME financing.

To facilitate operation of the SME sector, the SME report (2006) makes the following suggestions, which are equally applicable to the Islamic financial industry:

- Government measures to promote SMEs should be carefully focused, aiming at making markets work efficiently and at providing incentives for the private sector to assume an active role in SME finance.
- Public policy should improve awareness among entrepreneurs of the range of financing options available from official programs, private investors, and banks.
- The principles of risk sharing should be observed, committing official funds only in partnership with those of entrepreneurs, banks, businesses or universities.
- The tax system should not inadvertently place SMEs at a disadvantage.
- The legal, tax and regulatory framework should be reviewed in order to ensure that the business environment encourages the development of venture capital, including opportunities for exit.

### **Economic Development**

In addition to all the critical issues outlined above, the growth of Islamic finance will be determined by the growth and development of the real sector of Muslim economies. By this we do not mean growth of GDP alone. Growth in GDP can be accompanied by little or no financial development as, for example, would be the case if a country sells its oil abroad and imports all its needs. Broad-based economic development requires higher savings and investment, a more-educated and better-trained labor force, the adoption of modern technology and best practices, efficient institutions (especially the rule of law), consistent economic policies, and an environment where a vibrant private sector can grow and develop. The synergy between the real and financial sectors has been readily acknowledged. Economic growth in the real sector in such a setting will stimulate the financial sector, and the financial sector will in turn provide financing for the growing real economy. The largest and most-developed economies tend to have the largest and most-efficient financial sectors.

While Islamic finance continues to receive considerable attention, no attempt has been made for a system-wide implementation of the economic tenets of Islam. The challenge for Muslim countries wishing to embrace Islamic finance would be to understand the linkage between Islam's economic tenets and economic growth. Islam's notions of justice in exchange and distribution, the role of society and the state, instruments to promote social welfare, inclusiveness, and promotion of mutual and collective help can lead to an equitable and just economic system.

## **Public Finance**

One of the key elements for sustained growth and development in any modern economy is sound public finances; that is, adequate public revenues and prudent public expenditures that promote economic growth and social welfare. An overbearing government that runs large budgetary deficits and finances wasteful expenditures does significant harm to both economic growth and social welfare. An overbearing public sector crowds out private sector investment and growth. A government that runs large deficits reduces resources for the private sector, damages macroeconomic stability and reduces available policy options. Wasteful government expenditures, such as harmful subsidies and excessive military expenditure, reduce economic growth and adversely affect social welfare.

On the revenue side, efforts aimed at improving the elasticity and efficiency of the tax system need to be supported by improvements in administrative efficiency and tax enforcement. On the expenditure side, an improvement in the quality of public-expenditure programs, especially the elimination of indiscriminate subsidies and the adoption of a fair and just social safety net, would enhance their contribution to economic growth. However, while not all Muslim countries have warmed to the concept of the market economy and broad-based reforms, nearly all—to varying degrees—have taken timid steps to reduce fiscal costs and improve efficiency by tackling a variety of complex and politically sensitive issues. Such issues include the need to broaden the tax base and to reduce budget deficits; to address spending on subsidies, public-sector employment, pensions, and health; to use taxation and income transfers to achieve a fairer distribution of income and wealth; and to introduce greater transparency as part of governance reform. The attendant benefits of the improved fiscal conditions are also evident in lower inflation, smaller balance of payments deficits, more resources for private sector investment, and, quite recently, better growth rates.

## **Social Safety Net**

While over the last few decades the international community has adopted the position that broad-based economic growth is necessary for stemming the effects of systemic poverty, a growing consensus has emerged that social safety nets and social protection are also essential elements of any comprehensive framework for poverty alleviation. Not only are resources that provide basic services, such as health and education, important in their own right, they are also critical drivers for economic growth and development and essential to achieving an equitable distribution of income and wealth. An adequate social safety net is a central feature of Islamic economic doctrines and it is acknowledged to have a positive impact on economic growth and development.

In the early 1980s, the general prescription for growth in developing countries was economic reform, focusing on developing a prudent

combination of policies to enhance stabilization and adjustment. Little attention was given to the potential social costs of such reforms; reform was largely for reform's sake and did not incorporate the particular conditions of individual countries. However, by the late 1990s the pendulum had gradually shifted towards a model of economic growth that included more attention to relieving constraints that were binding to individual countries, including specific provisions for social welfare and protection. It has also been recognized that safety nets alone cannot serve effectively as an instrument for alleviating poverty without sound macroeconomic policies that enhance sustainable growth. While restructuring efforts may create economic efficiency gains over the long term, they often also lead to social dislocation, particularly over the short term. As Muslim countries adopt much-needed economic reforms to promote fiscal discipline (eliminating government waste, reducing harmful subsidies), build effective institutions (rule of law, reducing corruption), and promote economic justice in an effort to stimulate long-term growth, the development of a comprehensive structure to protect the vulnerable from falling deeper into poverty and to improve and broaden income distribution becomes even more pressing.

### **Developing Human Resources**

Education is today seen as a major, if not the major, input for sustained economic growth and development. A modern financial sector is dependent on having highly educated professionals in the fields of economics, finance, accounting, and IT. At the same time, effective and prudent supervision and regulation of the financial sector requires highly trained specialists. Unfortunately, all of these specialists are in high demand the world over and are highly mobile. High-quality university education, a good working environment and appropriate remuneration are key factors. Efforts should also be made to develop a multitude of customized research and training programs, with appropriate certification, in areas such as financial engineering and risk management. The need for cross-discipline activities to train *Shari'ah* scholars in economics and to train economists in the basics of *Shari'ah* principles cannot be overemphasized.

### **ENDNOTES**

1. Iqbal (2002).
2. Ali and Ahmed (2006).
3. Martson and Sundararajan (2006).
4. Macro prudential surveillance refers to monitoring the impact of plausible macro-economic shocks on financial soundness and of the implications of financial soundness on the macro economy, and adjusting macro and financial policies, as needed.
5. US debt includes US Treasury, mortgage-related debt, corporate, and agency debt. Source: Securities Industry and Financial Markets Association (SIFMA), <http://www.sifma.org>

6. See Ali (2004) and Chapra (2006).
7. Chapra (2006) puts forward the idea of creating a common pool at the central banks to provide mutual accommodation to banks in case of need. All banks may be required to contribute a certain mutually agreed percentage of their deposits to this common pool, just as they do in the case of statutory reserve requirements. They would then have the right to borrow interest-free from this pool with the condition that the net use of this facility is zero (that is, drawings do not exceed contributions) over a given period of time. In a crisis situation the central banks may allow a bank to exceed the limit, with appropriate penalties, warning, and a suitable corrective program.
8. Rajan (2006).
9. Smith (1993).
10. Iqbal (2005).
11. See Chapra (2000); Khan and Habib Ahmed (2001); El-Hawary, Grais and Iqbal (2004); and Grais and Iqbal (2006).
12. Creane *et al.* (2003).
13. IRTI and IFSB (2006).
14. Ibid.

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